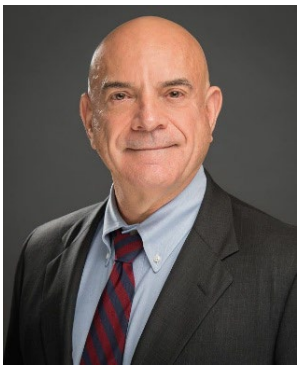
Texas Sales Tax for the Construction Industry

2024

This teaching manual/outline provides information on general tax issues and is not intended to provide advice on any specific legal matter or factual situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.

Instructor



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Chapter I. Overview

Texas Tax for the Construction Industry

Different types of Texas state taxes apply to the parties and transactions associated with real estate construction. These Texas taxes include the:

- sales & use tax on materials, supplies, equipment, and services.
- TERP surcharge tax on off-road diesel construction equipment;
- motor vehicle tax,
- motor fuels tax, and
- cement production tax.

This course focuses its discussion on the Texas sales & use tax, and briefly discusses the TERP surcharge tax, the motor vehicle and motor fuels taxes as applied to the construction industry.

Texas Sales & Use Tax

Although many types of taxes apply to the construction industry, the most significant tax is the sales & use tax. The Texas Limited Sales, Excise and Use Tax Act imposes a tax on the sale, lease, or rental of tangible personal (touchable, movable) property and on certain specified services.[1] Sales & use taxes are complementary. Together, they are intended to uniformly tax transactions only once, whether in or out of Texas. Sales & use taxes account for 58.6% of all state revenues, roughly six times the contribution of any other tax.

Sales Tax

Texas imposes sales tax on retail sales of taxable items in Texas. The state rate is 6.25%, although various local jurisdictions may impose sales and use taxes. The maximum combined tax rate for local taxes may not exceed 2% at any location. Therefore, the maximum possible sales tax rate is 8.25%.

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[1] Chapter 151 of the Texas Tax Code.

Example

Alpha Construction is located in San Antonio. It purchases a diesel-powered backhoe from a supplier located in Houston. Alpha must pay sales tax on this purchase. The law treats Alpha Construction as the consumer of the backhoe because its workers will use it to perform services at construction sites.

☞ ***Note:*** It doesn't matter whether Alpha Construction uses the backhoe to provide taxable or non-taxable services. This transaction is subject to both the sales tax and the TERP surcharge.

Use Tax

This tax presumptively applies when items are acquired out-of-state and brought into Texas within one year of purchase for storage, use, or consumption in Texas. Since the sale is made by a non-Texas seller, the seller would not collect Texas sales tax at the time of sale. Moreover, the seller would likely not collect the origin state's sales tax because the item is destined for Texas. This transaction is subject to the Texas *use* tax.

Without the use tax, persons could purchase items from an out-of-state retailer, use the items in Texas, and escape paying any tax. The use tax prevents this abuse and places out-of-state vendors on an even playing field with Texas vendors. The use tax applies to "any taxpayer who purchases tangible personal property from any retailer for storage, use or other consumption in Texas."[2]

Example

Alpha Construction purchases the backhoe from a supplier located in Tulsa and has the backhoe delivered to its yard in San Antonio. Alpha Construction owes Texas use tax and the TERP surcharge. If sales tax was legally-owed and paid in Oklahoma, Alpha Construction would be entitled to a tax credit against the Texas use tax for the Oklahoma sales tax paid. If the Oklahoma retailer lacked nexus with Texas or did not otherwise collect Texas sales tax, Alpha Construction must accrue and remit Texas use tax.

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[2] Texas Tax Code § 151.101.

Example

Alpha Construction orders lumber online for use in constructing a home in Texas under a lump-sum contract. The out-of-state lumber vendor does not charge or collect Texas sales and use tax from Alpha Construction. Alpha Construction owes Texas use tax. Local use taxes are based upon where it first uses or stores the lumber.

Applied to Construction Services

Construction services include all forms of real property work, including new construction, real property improvements, repairs, remodeling, restoration, and maintenance of both residential and non-residential (commercial) properties. Construction companies' services and purchases (materials, supplies, equipment) may be subject to Texas sales & use tax.

Certain Texas sales & use tax provisions frequently apply to construction work. They include the provisions that impose the sales tax on charges for these types of taxable items:

Materials Incorporated into Real Estate. The Texas Tax Code imposes the sales tax on sales of tangible personal property. For example, if a contractor purchases roofing material, the sale is subject to the Texas sales tax.

Supplies Consumed at the Construction Site. The Texas Tax Code imposes the sales tax on the purchase of supplies that are consumed in the course of the taxpayer's business or while providing services (taxable or non-taxable). For example, a contractor performing a lump-sum contract owes sales tax on the electricity that is consumed at the construction site by power tools.

Equipment Used to Provide Services. The Texas Tax Code imposes the sales tax on the purchase of equipment and tools used to provide services (taxable or non-taxable). For example, a contractor owes Texas sales tax on the hammer and saws it purchases and uses to construct foundation forms at the site.

Leased Equipment (With and Without Operators). The Texas Tax Code and related Comptroller rules treat leases as taxable when the underlying property, if purchased outright, would be subject to tax. For example, a contractor owes sales tax on the monthly payments for the lease of a generator used to power field lighting. When taxable items, such as equipment, are leased with an operator, the application of the tax rules becomes more complex. We discuss these issues in further detail in the chapter discussing the Texas sales & use tax rules.

Real Property Services. Charges for certain types of services, such as surveying, grounds cleaning, weed control, and pest control are subject to the Texas sales & use tax. For instance, the charges a contractor pays to survey the construction site boundaries or for pest control at the construction site are taxable as real property services.

Commercial Real Property Repairs and Remodeling. The Texas Tax Code treats the charges for repairs to commercial real property as taxable. For example, the charges to repair a private road to a construction site are taxable.

Personal Property Repairs and Remodeling. The Texas Tax Code treats the charges for repairs and remodeling to tangible personal property as taxable. For example, the charges to repair construction equipment are subject to sales tax.

Insurance Services. Taxable insurance services include damage and loss appraisal services, inspection services, claims adjustment or processing, aesthetic effect or research services and insurance loss prevention services.

Data Processing Services. The term "data processing" includes a variety of services performed using a computer, including word processing, data entry, production, compilation, storage or manipulation. Twenty percent (20%) of the charge for data processing services is exempt from tax.

There is an exception for using a computer as a tool to help perform a professional service. In that case the charge is not treated as a data processing service.

Information Services. The charge for gathering and furnishing general or specialized news or other current information to others (including electronic data research or retrieval) and providing access to databases of such information is taxable is an information service. Twenty percent (20%) of the charge for information services is exempt from tax. Examples of taxable information services include subscriptions to financial, geological or similar databases; newsletters; scouting reports and surveys; multiple listing services; mailing lists; global positioning system information including driving directions; and similar services.

Security Services. The charge for security services is taxable. Security services are any service for which a securities license is required by the Private Security Bureau of the Texas Department of Public Safety under Texas Occupations Code §§ 1702.101 or 102. Examples include locksmithing, private investigators, armored car services, and vehicle location and tracking services.

Telecommunication Services. Taxable telecommunication services are defined as charges for the electronic or electrical transmission, conveyance, routing or reception of sounds, signals, data or information using wires, cable, radio waves, microwaves, satellites, fiber optics, or any other method. Examples include local and long-distance telephone services, including mobile, satellite, VOIP, fax, pager, and e-mail.

Texas Emissions Reduction Program (TERP) Surcharge

Texas law imposes a surcharge on the sale, use, lease, or rental of both off-road and on-road, heavy-duty diesel equipment and is based on the sale, lease or rental amount. We separately address the TERP surcharge as it applies to on-road motor vehicles below under the topic heading "Texas Motor Vehicles Tax." For off-road equipment the surcharge is 1.5% of the sales or lease price of certain equipment. Reports are due monthly, quarterly, or annually, based on the level of activity. The tax is due by the 20th of the month following the end of the taxable period.[3]

The surcharge applies not only to construction equipment, but also to other off-road, heavy-duty diesel equipment, such as:

- mining equipment,
- rock and gravel crushers,
- forklifts,
- cement mixers,
- tractors, and
- motorized cranes.

The surcharge does *not* apply to motor vehicles and equipment used directly in exploration and production at an oil or gas well site.[4] It also does not apply to recreational vehicles that are not held or used in the production of income.[5]

Contingent Expiration. The TERP surcharge will expire on the last day of the fiscal biennium during which the Texas Commission on Environmental Qualify publishes a

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3 Texas Tax Code § 151.0515.

4 Comptroller Rule 3.320(a)(1).

5 Texas Tax Code § 152.0215. A recreational vehicle is defined as a motor vehicle primarily designed as temporary living quarters for recreational camping or travel.

notice in the Texas Register regarding National Ambient Air Quality Standards.[6] The TCEQ is required to publish the notice once the environmental health standards imposed by governmental authorities are attained. The Comptroller has amended the TERP rules to implement this legislation.[7]

Surcharge on Off-Road Equipment. Texas assesses a surcharge on off-road equipment to comply with federal pollution emission standards. The surcharge is 1.5% and applies to most types of heavy-duty, diesel-powered equipment, including mobile and stationary equipment purchased, rented or leased in Texas or brought in from out-of-state.[8]

Off-road, heavy-duty diesel equipment includes all new or used off-road, heavy-duty diesel equipment classified as construction equipment, other than equipment used solely for agricultural purposes.[9]

Examples of equipment subject to the surcharge:

- pavers,
- plate compactors,
- rollers,
- paving equipment,
- signal boards/light plants,
- bore/drill rigs,
- concrete/industrial saws,
- cranes,
- off-highway trucks,
- rough terrain forklifts,
- rubber tire tractors/dozers,
- crawler tractors/dozers,

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6 H.B. 3745, 86th Leg., R.S. (codified as an amendment to Tex. Tax Code § 152.0215).

7 45 Tex. Reg. 763–64 (2020) (codified as an amendment to 34 Tex. Admin. Code § 3.96); 45 Tex. Reg. 382 (2020) (codified as an amendment to 34 Tex. Admin. Code § 3.320).

8 Comptroller Rule 3.320(b).

9 See Comptroller Rule 3.320(a).

- off-highway tractors,
- tampers/rammers,
- concrete pavers,
- scrapers,
- surface equipment,
- trenchers,
- excavators,
- cement and mortar mixers,
- graders,
- crushing/processing equipment,
- rubber tire loaders,
- tractors/loaders/backhoes,
- skid steer loaders, and
- dumpsters/tenders.

The surcharge for off-road equipment does not apply to:

- motor vehicles,[10]
- equipment used directly to explore for and produce oil & gas,
- repair or replacement parts or accessories related to the equipment,
- implements of husbandry (including equipment exclusively used on a farm or ranch to build or maintain roads or water facilities),
- processing machinery and equipment eligible for manufacturing exemption,
- machinery and equipment used to construct or operate a qualifying water or waste water system and exempt from sales tax under Texas Tax Code § 151.355, and

[10] Texas Tax Code § 152.0215 provides for TERP surcharges on certain motor vehicles. *See* discussion below under "Texas Motor Vehicles Sales Tax."

- recreational vehicles that are not held or used in the production of income.

Rentals & Leases

For financing leases where, at the conclusion of the lease, either title transfers to the lessee or the lessee has an option to purchase the equipment for a nominal price, the surcharge is 1.5% of the sales price if the lessee takes possession of the equipment on or after September 1, 2015, and 2% of the sales price if the lessee took possession of the equipment between July 1, 2003 and September 1, 2015.[11]

For all other bare, non-financing leases, called "operating leases," the surcharge is 1.5% of the lease payments if the lessee takes possession of the equipment on or after September 1, 2015, and 2% of the lease payments if the lessee took possession of the equipment between July 1, 2003 and September 1, 2015.[12]

Texas Motor Fuels Tax

Diesel Fuel Tax

The diesel fuel tax rate is 20 cents per net gallon or fractional part on which the tax is imposed under Texas Tax Code § 162.201.[13] The taxability rules differ for clear diesel and dyed diesel. Dyed diesel is diesel fuel that meets the federal dyeing and marking requirements and is intended for off-highway use only.[14] Dyed diesel fuel is commonly used to fuel off-road heavy equipment at construction sites. Dyed diesel fuel is exempt from the diesel fuel tax in specific circumstances, and detailed documentation requirements must be met by the taxpayer.[15]

Signed-Statement Holders. Under Texas Tax Code § 162.204(a)(8), motor fuels tax does not need to be collected on dyed diesel fuel sold or delivered to a purchaser who provides a Comptroller-issued signed statement that complies with the requirements of section

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11 Comptroller Rule 3.320(b)(2).

12 Comptroller Rule 3.320(b)(3).

13 Texas Tax Code § 162.202.

14 Texas Tax Code § 162.001(22).

15 Texas Tax Code § 162.204.

162.206. Section 162.206 requires a purchaser to furnish a signed statement that includes an end-user number issued by the Comptroller.[16]

To obtain the signed statement, a purchaser of dyed diesel fuel must fill out an application from the Comptroller to request an end-user number. The end-user number is called the "DD" number. Once the end-user number is issued, the purchaser must provide a valid end-user number and a signed statement to the dyed diesel fuel supplier.[17] The purchaser can then purchase up to 10,000 gallons per calendar month of dyed diesel fuel without having to comply with any special reporting requirements.[18] The distributor is required to comply with reporting requirements and the Comptroller can determine when a purchaser with an end-user number has exceeded its monthly purchase limit by reviewing distributor records.

The purchaser may either bring its fuel storage tanks to the distributor's location or enter into an arrangement with the distributor to have fuel delivered directly to the work site.

☞ ***Caution:*** The Comptroller will only allow the exemption without documentation from the purchaser if the off-road equipment at issue is a self-contained piece of equipment. For example, if the dyed diesel fuel is pumped directly into a forklift, then the purchaser does not have to provide a signed statement to the distributor. However, if the purchaser first pumps the diesel into a bulk storage tank and then transports that storage tank to a work site to fuel a forklift, then the purchaser would have to provide a Comptroller-issued signed statement to the distributor to demonstrate that the fuel is being used for off-highway purchases and is subject to the exemption.

Comptroller Policy: Signed Statement Rules Strictly Construed. Comptroller Rule 3.438(a) does not allow a licensed supplier or distributor to make a tax-free sale of any diesel fuel to a purchaser using a signed statement, unless the purchaser has an end-user

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16 Texas Tax Code § 162.206(a).

17 *See* Texas Tax Code § 162.206(a).

18 Texas Tax Code § 162.206(c) (The purchaser may make a purchase of up to 25,000 gallons per month tax free if the purchaser furnishes a signed statement stipulating that all of the fuel will be consumed in agricultural off-highway equipment, or if the purchaser furnishes a signed statement showing that the fuel will be consumed in the production oil and gas and furnishes a letter of exception issued by the Comptroller.).

number.[19] Comptroller hearing decisions demonstrate that the Comptroller applies this rule strictly.[20]

> *Example 1*
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> Good Farm is a nonprofit farmer's coop that sells items like fuel, oil, fertilizers, tires, and small tools. Good Farm sells dyed diesel to Fast Wheels, a trucking company, without collecting tax. Fast Wheels does not have an end-user permit. Instead, Fast Wheels furnished the end-user permit number of Roger, an individual shareholder of Fast Wheels, when it purchased the diesel.
>
> The Comptroller audits Good Farm for motor fuels tax and issues an assessment against Good Farm. Good Farm argues that it properly maintained all records and invoices in connection with the dyed diesel sales at issue and, even though the transactions were billed to Fast Wheels, the fuel was actually purchased and used by Roger, who had an end-user permit.
>
> Under Comptroller policy Good Farm's contentions will be denied.[21] The Comptroller applies a high burden of proof in cases involving the signed-statement exemption, stating the rationale that "the signed-statement exemption has historically been surrounded by pervasive fraud."[22]

☞ ***Caution:*** In order to take advantage of the signed-statement exemption, a seller should take care to ensure that the purchaser provides a properly completed signed statement, containing a valid end-user permit number for the invoiced entity or individual. Otherwise, the seller may be held liable for the uncollected tax.

Dyed Diesel Fuel Bonded User. Once the purchaser exceeds the monthly purchase limits for dyed diesel fuel, the purchaser must then apply for a dyed diesel fuel bonded user license, which is subject to specific reporting obligations.[23] Although the Tax Code

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19 *See* 34 Tex. Admin Code § 3.438(a).

20 *See* Comptroller Hearing No. 111,833 (2016) (STAR No. 201604885H); Comptroller Hearing No. 11,831 (2016) (STAR No. 201604884H).

21 *See* Comptroller Hearing No. 111,833 (2016) (STAR No. 201604885H).

22 *See id.* (citing Comptroller Hearing No. 30,089 (1993)).

23 *See* Texas Tax Code Ch. 162 for bonded user application requirements; *See* Comptroller Publication No. 98-723 for an overview of the record-keeping requirements for dyed diesel fuel bonded users, *available at* https://comptroller.texas.gov/taxes/publications/98-723.php.

includes a bond requirement, the Comptroller does not frequently enforce this license requirement unless the taxpayer has a poor filing history, or owes back taxes.

– **Distribution Log Requirement**. The Texas Tax Code requires users of dyed and undyed diesel fuel to maintain a distribution log showing the number of gallons of fuel used in off-highway equipment or for other nonhighway purposes in order to support a refund claim.[24] The Comptroller's rule contains a narrow exception for the oil and gas industry.

  Under Comptroller Rule 3.430(a)(15), a dyed diesel fuel bonded user who owns or operates an oil or gas well drilling rig that meets specific requirements may keep purchase and delivery records, and supply tank inventory records that document the amount of dyed diesel fuel used by the rig instead of maintaining the more detailed distribution log.[25] The specific requirements necessary to qualify for this exception are narrow. In sum, a drilling rig can only qualify for this exception in situations where the diesel fuel is hard-piped straight to a rig and the only other supply tank attachments are used to move the fuel storage tank to other locations, or for emergencies such as a fire or a leaking tank.[26] If a supply tank has a pump or nozzle connected to the tank, then the rig does not meet the requirements.

  ☞ ***Note***. It may be impossible to comply with this strict rule because it is common for oilfield supply tanks to have nozzles or hoses attached to fuel storage tanks. Under this rule, the Comptroller deems the full contents of the storage tank taxable if the oilfield services provider fails to comply with the detailed distribution log rules if the drilling rig does not meet the hard-pipe requirement.

Gasoline and Diesel Fuel Import and Exports

The Comptroller has amended the rules for documenting imports and exports of gasoline and diesel fuel. The rule provides new reporting requirements for subsequent sales in this state of tax-free gasoline or diesel fuel purchased for export and provides penalties for failing to report.[27]

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24 Texas Tax Code § 162.229(c); Comptroller Rule 3.430(a)(14) and (15).

25 *See* Comptroller Rule 3.430(a)(15).

26 *Id.*

27 45 Tex. Reg. 509–12 (codified as an amendment to 34 Tex. Admin. Code § 3.441).

Texas Motor Vehicles Tax

The current motor vehicle tax rate is 6.25 percent. The tax due on a motor vehicle, however, is calculated at the rate in effect on the date the owner purchased the motor vehicle in Texas or the date it was first brought into Texas.

Payment of the motor vehicle sales tax is the purchaser's responsibility. If the seller is not a licensed dealer, the purchaser is responsible for titling and registering the vehicle, as well as paying the tax to the county tax assessor/collector within 20 county working days of the purchase date.

If a purchaser trades in a motor vehicle to the seller as part of the purchase transaction, the purchaser owes tax on the difference. The allowance for the motor vehicle traded in is the value of the vehicle and not necessarily the equity in that vehicle. The trade-in allowance also applies to a purchaser's traded-in vehicle when purchasing a motor vehicle consigned to a dealer.

Motor vehicle tax is due on the consideration paid or to be paid for a motor vehicle, including all accessories or attachments affixed at the time of sale. Examples of accessories include items such as: a sideview mirror, trailer hitch, or grill guard. Examples of attachments include a major piece of equipment that performs a function such as: a concrete mixer or an air compressor.

To determine the amount of tax due on a motor vehicle, it is necessary to determine what accessories or attachments were affixed to the motor vehicle at time of purchase. A person may purchase a motor vehicle and accessories/attachments separately, but then combine them before the person actually registers the motor vehicle.

Motor vehicles, regardless of use or accessories or equipment attached, are subject to motor vehicle tax unless specifically exempted. Motor vehicle tax is calculated on the purchase price including all accessories and equipment attached at the time of purchase. Accessories or equipment purchased in a separate transaction are subject to limited sales or use tax.

The type of registration and titling required by TxDMV does not determine the tax liability.

Accessories & Attachments.

There are three situations that occur when accessories/attachments are purchased with a motor vehicle:

- Accessories/attachments are affixed to the motor vehicle at the time of sale;

- Accessories/attachments are purchased separately from the motor vehicle; or
- Accessories/attachments are purchased to combine into a homemade or shop-made motor vehicle.

Accessories/Attachments Affixed at the Time of Sale.

Motor vehicle tax is due on the total selling price of a motor vehicle with affixed accessories or attachments:

Example 1

A customer orders a truck with a toolbox and grill guard accessories attached. The customer pays motor vehicle tax on the truck, the toolbox, grill guard and any other attached accessories.

INVOICE

Apple Motors
Austin, Texas

Crew Cab	$30,900
Tool Box	350
Grill Guard	750
Total	32,000
Motor Vehicle Sales Tax 6.25%	**2,000**

Accessories/Attachments Purchased Separately.

When a buyer purchases a motor vehicle and then purchases unattached accessories separately, motor vehicle tax is due on the motor vehicle's selling price. General sales tax is due on the selling price of the unattached accessories. The buyer may purchase the motor vehicle and the accessories from different sellers or from the same seller at different times. Generally, if the buyer purchases the accessory/attachment and the motor vehicle at the same time from the same person, it is considered the sale of a motor vehicle with an accessory/attachment, regardless of how the seller prepares the invoices.

Example 1

Customer purchases accessories to add to a completed truck on which the customer has already paid motor vehicle tax. Customer pays general sales tax on the purchase of the accessories and any labor to install them.

Example 2

Customer purchases a truck cab and chassis (see A) and a truck body (see B) from separate suppliers and assembles the truck. Customer pays motor vehicle tax on the truck cab and chassis and pays general sales tax on the truck body to the body company.

INVOICE (A)

Truck Store

2010 Cab-Chassis	$44,000
Motor Vehicle Sales Tax 6.25%	**2,750**
Total	**$46,750**

INVOICE (B)

Welding Supply, Inc.

Flat Bed	$2,500
Tool Boxes	800
Welding Rigs	4,500
Subtotal	**7,800**
Installation	1,000
Subtotal (before taxes)	**8,800**
General Sales Tax 8.25%	**726**
Total	**$9,526**

Accessories/Attachments Purchased to Combine into a Homemade or Shop-Made Motor Vehicle.

When a buyer purchases parts and accessories to be combined into a motor vehicle and no single part or accessory is a motor vehicle, no motor vehicle tax is due when the builder initially titles the motor vehicle. The purchaser owes the general sales tax on all the parts and accessories to the seller.

Example 1

Customer orders parts, materials and accessories, none of which are motor vehicles, and assembles them into a truck. Customer owes the general sales tax to the seller on each part or accessory purchased. No motor vehicle tax is due when the customer initially titles the truck.

INVOICE

Custom Truck Accessories

Grill Guard	$350
Tool Box	750
Subtotal	**1,100**
General Sales Tax 8.25%	**91**
Total	**$1,191**

The only time motor vehicle tax is not due on a homemade or shop-made motor vehicle is when the person who actually built the motor vehicle initially titles it. Once the person who built the motor vehicle has titled or registered it, motor vehicle tax is due on any subsequent sales. Motor vehicle tax is due from the person who custom orders a motor vehicle because someone else is the actual builder.

TERP Surcharge. The TERP surcharge applies to the purchase, sale or lease of on-road diesel motor vehicles over 14,000 pounds that are leased in Texas.[28] For leased vehicles the lessor must pay at the time it purchases the vehicle for sale. Thus, in the case of motor vehicles, the sale for resale exemption *does not* apply to the TERP surtax. The TERP surtax is based on the total consideration paid by the lessor at the time it registers and titles the vehicle and is imposed at a rate of 1 percent for vehicles with model years 1997 or later, and 2.5 percent for vehicles with model years 1996 or earlier. The surcharge is not due on the lease receipts paid to the motor vehicle owner.[29]

Trailers. Trailers and semi-trailers are motor vehicles and are subject to motor vehicle tax, unless specifically exempt. For example, farm trailers are exempt from motor vehicle tax.

Trailer Types. Trailers include regular trailers; semi-trailers; house trailers, such as travel trailers; bunkhouse trailers; and other trailer types, such as: towable dollies, jeeps, stingers, auxiliary axles and converter gears. Park models, manufactured housing and mobile offices are not taxed as motor vehicles. Towable, moveable specialized equipment is not taxed as motor vehicles.

Registration and Titling. Some trailers are not titled but are subject to motor vehicle tax. The type of registration and titling required by TxDMV does not determine the tax liability of a trailer.

Tax Receipt. When a trailer does not require a negotiable title, but motor vehicle tax is due, the county TAC will issue a tax receipt for tax and registration purposes.

Interstate Motor Vehicles. Motor vehicles that are operated in interstate commerce are exempted from motor vehicle tax. An "interstate motor vehicle" is defined as any motor vehicle that is operated in Texas and in at least one other state or country, and for which the registration fees could be apportioned if the motor vehicle were registered in a state or province of a country that is a member of the International Registration Plan (IRP).

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28 *See* Texas Tax Code § 152.0215.

29 *See* Comptroller Rule §3.96(b) and (c)(2).

The International Registration Plan (IRP) is a registration reciprocity agreement between the contiguous United States and Canadian provinces, which provides apportioned payments of registration fees based on the total distance operated in participating jurisdictions.

The State of Texas is a member jurisdiction of the IRP. The International Registration Plan as an international method of registering fleets of vehicles that travel in two or more states or provinces. IRP motor carriers register fleets of vehicles in their home state (the "base jurisdiction") and the home state apportions the registration fees to the other traveled states of the carriers.

Under the IRP agreement, commercial carriers pay a proportionate or "apportioned" amount of registration fees to each jurisdiction in which they operate. The fees charged are based on the distances apportionable vehicles travel in each jurisdiction relative to the total distance traveled. An "apportionable vehicle" is defined as any commercial vehicle used or intended for use in two or more member jurisdictions and is used for the transportation of persons for hire or designed, used, or maintained primarily for the transportation of property.

Apportionable fees are paid to the various jurisdictions in which the vehicles are operated, but the only license plate and cab card issued for each vehicle are those issued by the base jurisdiction. Commercial carriers benefit from apportioned registration because they can travel throughout the United States without having to register with each individual jurisdiction.

Chapter II. The Texas Sales & Use Tax Rules

Introduction

We begin with a general discussion of the Texas sales & use tax rules that frequently apply in the construction industry. They include the rules that impose the sales tax on charges for incorporated materials and consumed supplies, equipment (either purchased or rented), and certain taxable services. The rules for some taxable services apply differently to real property and tangible personal property, so we need to know how to classify different types of property. We also discuss the exemptions that are either directly related to or common in the construction industry.

> **The Texas Tax Code imposes sales tax on the "sales price" of each "sale" of a "taxable item" in "Texas."**[30]

Sales Price

This is the amount for which a taxable item is sold, leased or rented without a deduction for the cost of transportation and other costs.

Entire Price Charged by the Seller. When a taxable item is sold, the tax laws impose the sales tax on the seller's entire charge, regardless of whether individual components of the sale are stated separately or stated on different invoices. As a result, separately stating items (such as freight or transportation and similar costs) will not transform them back to non-taxable charges. They will remain a component of the taxable sales price.

Exception for Independent Transactions. This rule does not apply when the items are independently desired and provided and are readily separable into two elements. The case of *Rylander v. San Antonio SMSA Ltd. Partnership*[31] illustrates this point. In *Rylander v. San Antonio SMSA Ltd. Partnership*[32] SMSA operated cellular telephone companies. SMSA needed to expand its network and install new networking equipment. SMSA contracted with AT&T to provide both engineering services and telecommunication equipment. SMSA needed engineers to develop plans for the expansion and to prevent service interruption while the new equipment was put into place. AT&T separated the charge for the engineering services from the charge for the equipment. AT&T taxed only the

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30 Texas Tax Code § 151.051.

31 11 S.W.3d 484 (Tex. App.—Austin 2000, no pet.).

32 11 S.W.3d 484 (Tex. App.—Austin 2000, no pet.).

equipment. The Comptroller claimed that the entire payment was subject to tax under the sales price rule.

The court held the engineering services were not taxable. The court reasoned that the engineering services were independently desired, and AT&T would have sold them separately. The court's decision was not affected by AT&T's use of a single contract and single invoice to bill for both items.

Exception for Certain Charges. Certain charges, if separately stated, are not subject to the tax. These include discounts, refunds, returns, finance charges, and trade-ins.[33]

Definition of "Sales"

Texas imposes a tax on sales. A "sale" occurs when the taxpayer transfers title or possession of a taxable item including tangible personal property for consideration (*i.e.*, money or some other value).

The statute states several types of transactions that constitute "sales" when done for value (or consideration). The following types of sales are common in the construction industry:

Title. Transferring title of tangible personal property is a sale. A sale still occurs if the seller keeps possession of the item sold but passes title.

Possession. Transferring possession of tangible personal property is also a sale if the possession is in lieu of transferring title or constitutes a barter or exchange.

Segregation. Merely segregating items in contemplation of transferring title or possession does not create a sale.[34]

Exchanges. The exchange or barter of tangible personal property constitutes a sale.

Trade-Ins. A trade-in to reduce the purchase price of a taxable item is a taxable barter, but only if the item given by the buyer is not sold in the seller's regular course of business.[35]

Leases or Rentals. The lease or rental of tangible personal property without furnishing an operator constitutes a sale. There are two broad categories of leases: operating leases and financing leases.[36] Both are taxable. However, the amount of tax and when it is paid is different for each.

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33 Texas Tax Code § 151.007.

34 Note that earlier versions of the statute treated segregation as a sale.

35 Comptroller Rule 3.302(g).

36 Comptroller Rule 3.294(a)(1).

Services. Performing a taxable service constitutes a sale. The Texas Tax Code treats seventeen (17) categories of services as taxable.[37]

Production. Producing, fabricating, processing, printing, or imprinting tangible personal property for persons who furnish the materials. Examples include developing photographs, tailoring, assembling toys and furniture, printing, calligraphy, and catering.

Divergent Use. Divergent use occurs when an item is initially purchased under a valid claim of an exemption and later the taxpayer uses the item in a taxable manner. For example, when a company removes an item from its inventory for its own use, it will owe use tax on the cost of the item.[38]

Taxable Item

"Taxable Item" means tangible personal property and taxable services.

Tangible Personal Property. This is property that can be weighed, measured, felt or touched, or that is perceptible to the senses in any other manner, including computer programs and digital products.[39]

Taxable Services. In addition to taxable items, Texas also imposes sales tax on a list of specific services.[40] Many of these services are relevant to the construction industry, including the repair, remodeling, maintenance, and restoration of tangible personal property, and real property services.

Presumptions About Taxability. The tax laws presume that all sales or uses of tangible personal property are taxable. However, this presumption does not lie for charges for the performance of taxable services.

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37 Texas Tax Code § 151.0101.

38 Texas Tax Code § 151.3181 covers divergent uses of tangible personal property in the manufacturing process. This special divergent use rule is discussed later in these materials.

39 Texas Tax Code § 151.009.

40 Texas Tax Code § 151.0101.

Essence of the Transaction Doctrine

Whenever a service provider's contract or invoices contain a single charge for providing both taxable and non-taxable services or when the contract encompasses both a non-taxable service and a taxable sale, the Texas courts examine the taxability of the transaction under the "essence of the transaction" doctrine. Under this doctrine, courts examine the intent or basic purpose of the parties entering into the transaction to determine its overall nature or "essence." If the parties intend to sell/buy a taxable service or tangible personal property, then the entire charge is taxable. The courts do not split the service or item into separate components and establish the separate taxability of each.

In *Williams and Lee Scouting Service, Inc. v. Calvert*,[41] the taxpayer sold oil well and field reports on computer tape to its customers. The court held the sale was for a non-taxable service and did not constitute the sale of tangible personal property (*i.e.,* the computer tape). The "essence of the transaction" was the purchase of the information contained on the tape, and because information services were not yet taxable in Texas, the Court held that the transaction was, in essence, a non-taxable service.

In *Austin Engineering Co., Inc. v. Combs*, [42] the taxpayer provided erosion control services. The taxpayer installed silt fences and other erosion control devices as part of this service and charged a lump-sum fee for "erosion control improvements." The taxpayer argued that it provided non-taxable services. However, the Third Court of Appeals disagreed and found that the taxpayer made taxable sales of tangible personal property. The court reasoned that the "essence of the transaction" was that the customer wanted "erosion control on the construction site," which the erosion control devices themselves provided.

☞ ***Important Note.*** The "essence of the transaction" doctrine is an all-or-nothing rule of law. A charge is either completely taxable or it is completely non-taxable. Therefore, if a taxpayer is able to show that the basic purpose of the transaction is the performance of a non-taxable service, sales tax is not due even on the portions of the service which are admittedly taxable. This is true even if the charge is separately- stated.

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41 452 S.W.2d 789 (Tex. Civ. App.—Austin 1970, writ. ref'd).

42 No. 03-10-00323-CV, 2011 WL 3371557 (Tex. App.—Austin 2011, no pet.).

Entity Concept

Texas law follows the separate entity concept. The law treats each person or entity as a separate taxpayer regardless of whether they are owned or controlled by the same person(s). Accordingly, transactions between related taxpayers are usually subject to the sales or use tax. This includes, for example, the lease of equipment from an owner to his wholly-owned corporation. Sales between two separate corporations, even if they are related as brother-sister or parent-subsidiary, are subject to sales & use tax. Sales or transfers between two divisions or agencies of the same corporation are not subject to sales tax even though the two divisions may treat the transfer as a sale and purchase on their records.

Credit for Tax Paid to Other States

Texas is a member of the Multi-State Tax Compact. As a member, Texas law allows a credit against Texas use tax for sales tax paid on the item to another state, if the other state grants Texas taxpayers reciprocal treatment.[43]

Legally Due Requirement

Texas only allows the credit if the sales tax was legally due in the other state.[44] Texas generally defers to the other state's interpretation of whether tax was legally due.[45]

> *Example*
>
> Under Louisiana sales tax law, a corporation owes sales tax if the buyer arranges for shipment from Louisiana to an out-of-state location. Louisiana sales tax is not due if the Louisiana seller ships the items to an out-of-state location either using its own vehicles or by common carrier hired by the Louisiana seller.[46]

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43 Texas Tax Code § 151.303(c).

44 Comptroller Rule 3.338.

45 Comptroller Hearing No. 36,403 (1997).

46 Comptroller Hearing No. 36,403 (1997).

Example

A Louisiana company buys crushed rock in bulk and has the rock shipped to its location in Shreveport, Louisiana. The company pays Louisiana sales tax of 4% on the crushed rock. The company uses the materials in Texas in performing a lump-sum contract to repair private roads to oilfield sites located in East Texas. Texas auditors allege that the Louisiana company owes Texas use tax on the crushed rock unreduced by the 4% Louisiana sales tax if sales tax was not legally due in Louisiana.

Nexus

A business is "engaged in business" when it has some economic, virtual or physical connection with a taxing jurisdiction. In tax parlance, we call this "nexus."[47] Sometimes the sales tax auditors use the term "representation" instead of "nexus." Whether a taxpayer has nexus with a state determines the taxpayer's collection responsibilities in that state.

Out-of-State Commercial Repair and Maintenance Provider had Nexus with Texas. An Ohio-based corporation that utilized local independent contractors to provide repair and maintenance services nationwide, including to Texas retail stores, had sufficient nexus with the state to confer the burden of collecting and remitting Texas sales tax on its services.[48]

As part of its business model, the taxpayer entered into contracts with retail stores for electrical lighting repair and maintenance, HVAC, plumbing and carpentry services.

The company handled all aspects of completing the work requested by the customer, including contacting its network of local independent contractors, requesting bids from those contractors, overseeing the bidding process, monitoring the local contractors' performance, and all aspects of quality control, and its preferred fee arrangement with its independent was to collect a percentage of the charge for the work that was performed at the customers' stores.

Despite the fact that the company did not have a physical location in Texas, did not directly advertise in Texas and did not have any Texas-based employees, the Comptroller determined that it established, operated, and maintained a presence and market in Texas by virtue of its contracting with Texas vendors to perform services in Texas.

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47 "Nexus" means "connection" in Latin.

48 Comptroller Decision, Hearing No. 111,156 (September 2017).

Registration, Permit and Reporting Requirements

Sales/Use Tax Permits. Sellers must obtain a sales tax permit for each place of business in Texas. Out-of-state sellers selling items for use in Texas must obtain a use tax permit if they have sufficient nexus with Texas. Sellers are required to report monthly, quarterly or yearly depending upon the amount of tax they expect to remit. The Tax Code permits taxpayers to electronically sign and file applications for sales and use tax permits.[49]

Place of Business. A store, office or other location, other than an (automated) kiosk, where you receive orders for taxable goods or services at least three times during the calendar year. A warehouse or other storage facility is not a place of business unless three or more sales are made or orders taken there during a year.

Sales and Use Tax Reports. These are generally due on the 20th day of the month following the month of sales, except for quarterly and yearly filers.

Taxpayers may choose to report sales tax on either a cash basis or accrual basis. The election is made by using the chosen method on the first filed report.

☞ ***Note.*** Cash basis taxpayers do not have to remit sales tax on deposits until work for which the deposit was made is performed.[50]

Example

Outdoor Escape provides residential and commercial landscaping services. Outdoor Escape enters into contracts to design and install landscaping and hardscaping. When a customer approves a design, Outdoor Escape requires the customer to make a deposit against future charges for installation of the landscaping and hardscaping. Outdoor Escape doesn't begin invoicing the customer until it begins performing the services. Outdoor Escape is on the cash basis accounting system, and does not collect, report, or remit sales tax on customer deposits until it actually completes a task and invoices the customer.

Outdoor Escape is not required to report and remit sales tax at the time it receives a customer's refundable deposit. Outdoor Escape is required to report and remit sales tax when it invoices its customer and applies the deposit as payment for a completed task.

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49 Texas Tax Code § 151.202(c).

50 *See* Comptroller Letter No. 201705002L (May 2, 2017).

Electronic funds transfer. Taxpayers who paid $10,000 or more in Texas taxes during the preceding state fiscal year are required by law to electronically transmit their tax payments to the Comptroller's office by electronic funds transfer (EFT).[51] The taxes affected by this law are Sales & Use Tax, Direct Pay, Natural Gas, Crude Oil, Franchise, Gasoline, Diesel Fuel, Hotel Occupancy, Insurance Premium, Mixed Beverage Gross Receipts, and Motor Vehicle Rental.

A $100,000 threshold applies to all other taxes not mentioned above. Taxpayers who pay over $100,000 must make their electronic payments by TEXNET.

Electronic filing. All taxpayers may now file Texas sales and use tax returns online using the Comptroller's WebFile system. The Comptroller requires taxpayers who paid amounts exceeding the threshold during the preceding state fiscal year to electronically file reports. This requirement only applies to taxpayers who have received notice of this requirement from the Comptroller 60 days in advance of the filing deadline.[52] Taxpayers who owe less than or equal to $100,000 per year may file electronically and pay by Discover, American Express or electronic funds transfer at:

https://comptroller.texas.gov/taxes/file-pay/about-webfile.php

Credit for Early and Timely Payments.

Timely Payment. Sellers who pay their sales tax liability on time are entitled to a 0.5% discount on the payment.

Prepayment. Sellers may obtain a discount of 1.25% of the amount of sales tax by prepaying the tax. Monthly filers who prepay at least 90% of the entire tax by the 15th of the month for which the tax is paid (*i.e.*, an estimated amount equal to at least 90% of what the final amount turns out to be) are entitled to an "additional" 1.25% discount on the payment.[53] We believe that the word "additional" means that you would also be entitled to the 0.5% timely payment discount. Quarterly filers who pay at least 90% of the final liability by the 15th day of the second month of the quarter are also entitled to the 1.25% discount.

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51 Comptroller Rule 3.9.

52 Comptroller Rule 3.9(f).

53 Texas Tax Code § 151.424.

Local Sales & Use Taxes

Place of Business.

A place of business is store, office or other location where you receive orders for taxable goods or services at least three times during the calendar year. A warehouse or other storage facility is not a place of business unless three or more sales are made or orders taken there during a year.

Sales & Use Tax Permits. Sellers must obtain a sales tax permit for each place of business in Texas. Out-of-state sellers selling items for use in Texas must obtain a use tax permit if they have sufficient nexus with Texas. Sellers are required to report monthly, quarterly or yearly depending upon the amount of tax they expect to remit.

Local Sales Tax.[54]

Generally, local *sales* taxes are collected based on the location of the *seller's place of business*. A "place of business" is a store, office, or other location operated for the purpose of receiving orders for taxable goods or services. A manufacturing plant, warehouse or other location not operated for the purpose of receiving orders for taxable items is not a place of business, unless three or more sales are made there, or orders are taken there, during a year.

One Place of Business. If the seller's only place of business is in a local city, county special purpose district, and/or transit authority taxing jurisdiction, sales tax is collected for those jurisdictions on *all* sales of taxable items made to customers in Texas.

More Than One Place of Business. When a seller has more than one place of business in Texas, the local tax collected is determined by the place of business from which the items are *shipped*, not the location where the order is received.[55] If the seller ships items from a place of business in a taxing jurisdiction, local sales tax must be collected for that jurisdiction.

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54 *See* Guidelines for Collecting Local Sales & Use Taxes. Comptroller Bulletin (February 2009).

55 However, if the order is placed in person (e.g., at a furniture showroom), the local taxes are sourced to that location. Texas Tax Code § 321.203(c).

Orders Received at a Place of Business in Texas; Products Delivered by Third Party Vendor Located Outside Texas. If a seller receives an order at a place of business in Texas, and the taxable goods or services are delivered to Texas customers by a third-party supplier located outside of Texas, the seller must collect local sales tax based on the place of business where the order was received.

Example

A seller operates a place of business in Round Rock and receives an order from a customer for an item that must be ordered from a supplier located outside of Texas. The seller receives payment for the item from the customer. The seller instructs the supplier to ship the item directly to the customer's location in Texas rather than shipping it to the seller's place of business. Based on these facts, the seller should collect local sales taxes based on its place of business in Round Rock, which is the place of business where the order was *received*.

If a seller receives an order at a place of business in Texas, and the taxable goods or services sold are delivered to the customer in Texas from *the seller's* place of business located outside of Texas or from *the seller's* warehouse, distribution center or other location outside Texas (even if it is not a place of business that takes orders), the seller must collect local use tax based on where the product is *delivered*.

Local Use Tax

Local use tax is collected based on where the customer receives the goods or services: the point of delivery. Texas sellers may be required to collect local use taxes if they are engaged in business in the local taxing jurisdictions in effect at the point of delivery unless the two percent (2%) cap for local taxes would be exceeded.

Engaged in Business. If a seller of taxable items engages in any of the types of activities that create nexus in an out-of-state company within a local jurisdiction, then the seller may be required to collect local use tax on taxable goods or services delivered into that jurisdiction. For example, the use of company vehicles (whether owned, leased or rented) to deliver taxable items to customers in the taxing jurisdiction means a seller is engaged in business there.

No Place of Business. If a seller has no place of business in Texas, the seller should collect local *use* tax for the city, county, special purpose district, or transit authority jurisdictions in effect where the product is delivered if the seller is *engaged in business* in the jurisdiction.

Example

Beta Flooring is headquartered in Tulsa and sells tile to contractors at construction sites located in Texas. It has no place of business in Texas. Its traveling salesmen carry samples and take orders for tile from Beta's customers at their construction sites and Beta delivers the tile to the construction sites. Beta Flooring should collect local use tax based on the location of the construction sites.

Orders Placed at a Seller's Place of Business in Texas; Products Delivered from a Seller's Out-of-State Location. If a seller receives an order at a place of business in Texas and the taxable goods or services sold are delivered to Texas customers from the seller's out-of-state location, and if the seller is engaged in business where the product is delivered, the seller should collect *use* tax for any city, county, special purpose district, and/or transit authority jurisdictions in effect where the product is delivered, if the seller is *engaged in business* in the jurisdiction.

Orders Placed with a Seller Located Outside Texas; Products Delivered from Within Texas. If a seller receives an order at a place of business located outside of Texas, but delivery or shipment is made to a customer in Texas from a location within the state that is not a place of business (such as a warehouse or distribution center), the seller must collect *use* tax for any city, county, special purpose district, and/or transit authority jurisdictions in effect where the product is delivered, if the seller is *engaged in business* in the jurisdiction.

Order Received by Salesperson Located Outside Texas; Products Delivered from Within Texas. If an order is received by a salesperson assigned to a place of business located outside Texas, and delivery or shipment is made from a location within Texas other than a place of business of the seller such as a warehouse or distribution center, the seller must collect *use* tax for the city, county, special purpose district, or transit authority jurisdictions in effect where the product is delivered if the seller is *engaged in business* in the jurisdiction.

Important Exception for Contractors with Separated Contracts for New Construction and for Residential Repair and Remodeling Projects. A *separated contract* provides separate charges for materials and labor. A contractor working under a separated contract for residential construction, new commercial construction, or for residential repair and remodeling must collect local taxes on the charge for materials based on the location of the job site. The same rule applies to charges for commercial repairs and remodeling, regardless of the contract type.

Under a *lump-sum contract* for residential repair and remodeling or new construction (residential or nonresidential), the contractor is considered the consumer of all materials and must pay tax to suppliers at the time of purchase; the contractor does not collect sales tax on the charge to the customer. If the supplier delivers goods to the job site, the supplier should collect sales tax from the contractor based on the location of the supplier's place of business and may also collect local use taxes based on the point of delivery. A lump-sum contract is a contract in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separately-stated from charges for labor.

Record Retention Guidelines

Sales records must be kept for a minimum of four years.[56] This applies to all contractors, vendors, subcontractors, repairmen, remodelers, consumers of taxable items, and taxable service providers. The statute is extended indefinitely when no report is filed, the report is fraudulent or the report omits twenty-five percent (25%) or more of the tax required to be shown due on the report.[57] If you are undergoing an audit or a challenge to a tax assessment, you must retain all of the relevant records until the underlying assessment is resolved by settlement or litigation.

Direct Pay Permits

Purchasers who buy at least $800,000 of taxable items for their own use may apply for a permit that allows the purchaser to pay sales tax on the purchased items directly to the Comptroller. This is in lieu of having the seller of items collect the sales tax from the purchaser and remit it to the Comptroller. A searchable listing of direct payment permit holders is available on the Comptroller's web site at:

https://comptroller.texas.gov/taxes/sales/direct-pay-search.php

Requirements. The applicant must agree to accrue and pay use taxes that become due by the statutory due date, waive the timely payment and filing discount and file all applicable state, city and MTA returns.[58]

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56 Texas Tax Code § 111.0041.

57 Comptroller Rule 3.339.

58 Texas Tax Code § 151.419(b)(1).

Proper Accounting Methods. The direct pay permit applicant must show the Comptroller that its accounting methods clearly distinguish between taxable and non-taxable purchases.

Percentage Based Reporting. Permit holders may elect to determine their taxable purchases using a sample percentage. The permit holder must apply to the Comptroller for a letter authorizing the permit holder to use the sample. The Comptroller must agree with the items to be sampled and they must be representative of the business's purchases. Authorized sample percentages must be used for a three-year period.[59]

Using the Permit. Once the taxpayer receives a direct pay permit, it should use a direct payment exemption certificate for purchases for its own use and a resale certificate for purchases for resale. The permit holder must report its purchases monthly on the direct payment return. The permit holder may not report purchases on the sales and use tax return because the timely filing discount is not allowed for direct payment purchases.

Local Use Taxes. Local use taxes are determined based upon the location where the taxable items are first used, stored, or consumed.

[59] Texas Tax Code § 151.4171.

Example 1

Dream Homebuilders is a direct payment permit holder with locations both within Texas and outside Texas. Dream Homebuilders purchases lumber from a supplier located in Georgia and stores the lumber in its Austin warehouse.

If Dream Homebuilders purchased the item for use in Texas, Dream Homebuilders owes Texas use tax when it brings the item to Texas.

If Dream Homebuilders had not determined where it intended to use the item when it bought it, Dream Homebuilders owes use tax either when the item is first stored or first removed for use in Texas. Dream Homebuilders must select a method (first stored or first removed for use) and use it consistently. Notwithstanding the foregoing applicable to state use tax, Dream Homebuilders must allocate local taxes to Austin, which is where the item was first removed from storage.[60] If Dream Homebuilders elects to report on the basis of first storage and later uses the items out-of-state and without any prior Texas use, Dream Homebuilders may take a credit for the Texas use tax it previously paid.

Dream Homebuilders will owe the following Texas taxes:

State:	Use Tax
City:	Austin Use Tax
Transit:	Austin MTA Use Tax

Example 2

Quality Contractors is a direct payment permit holder with locations both within Texas and outside Texas. Quality Contractors purchases a taxable item from a supplier located in Houston and stores the item in its Austin warehouse.

Quality Contractors owes the following Texas taxes:

State:	Use Tax
City:	Austin Use Tax
Transit:	Austin MTA Use Tax

[60] Texas Tax Code § 321.205(d); *see also* Comptroller Letter No. 200805278L (partially superseded). Note that had Dream Homebuilders not stored the lumber in Texas prior to use, Texas Tax Code § 321.205(d) requires it to allocate the local tax to the place where the lumber was first used or consumed after transportation.

Lump-sum Contractors. If the seller is a lump-sum contractor, he cannot accept the owner's direct payment certificate in order to purchase materials for a job tax-free. The contractor must pay the tax on the materials because the contractor is the ultimate consumer under a lump-sum contract. This applies primarily to new construction.

Exception for Taxable Repairs and Remodeling. A contractor may accept the owner's direct payment certificate for charges under a lump-sum contract when the work is taxable. For example, a contractor may accept the direct payment certificate when performing repairs and remodeling of commercial structures.

☞ ***Caution.*** Be sure to get the Direct Payment Permit form from the purchaser. You may not simply rely on a direct payment permit number shown on the buyer's purchase order.

☞ ***Caution.*** When dealing with large corporations, be sure to get the direct pay permit from the correct subsidiary or legal entity.

Materials, Supplies & Equipment

This section covers the Texas sales & use tax rules for various types of tangible personal property that's often located at, incorporated into, or consumed at construction sites.

Generally

Materials are items that are incorporated into real property improvements. Businesses that improve real property are classified as contractors. The contractor's agreement with its customer generally determines who owes the tax on materials.

Under a lump-sum contract, a contractor is considered the consumer of all materials incorporated into a customer's property. As a consumer, a contractor generally must pay tax to suppliers at the time the materials are purchased. The contractor will also pay sales & use tax on consumable supplies and all equipment bought, leased, and rented for use on the job. The lump-sum charge to the customer is not taxable.

Under a separated contract, a contractor is considered the retailer of all materials physically incorporated into the realty. As a retailer, a separated contractor must collect sales tax from the customer based on the agreed upon contract price of the incorporated materials. The separately-stated charge for labor may or may not be taxable. A separated contractor may issue a resale certificate to purchase the materials. The contractor must pay sales tax on consumable supplies and all equipment bought, leased, or rented for use on the job.

Example

ABC Windows sells and installs windows in office buildings. It bills its clients separately for the labor and material charges. The tax laws treat ABC Windows as the reseller of the windows to the owners.

We discuss the details of contract pricing and its effect on sales tax in Chapter IV.

Incorporated Materials

Incorporated materials are tangible personal property that becomes part of the real property. Tax responsibilities on incorporated materials are outlined in the "Contract Pricing" section of this manual. However, there are additional situations that need to be discussed to avoid pitfalls.

Incorporated materials include but are not limited to:

- lumber
- nails
- screws
- siding
- bricks
- shingles
- windows
- cement
- plumbing fixtures
- lighting fixtures
- electrical wiring
- breaker boxes
- paint
- pipe
- dry wall
- putty
- doors
- rebar
- corrugated metal
- tile

Materials Provided by the Customer.

A contract may specify that a customer will provide materials and the person performing improvements will provide the skill and labor necessary to perform the contract. Under this type of contract, the person providing the skill and labor will not incur tax liability on the materials; the customer is liable for the tax on the materials. The tax should be paid to the supplier when the materials are purchased.

Materials Purchased in Texas for Use Outside of Texas.

Tax is due in this state on materials purchased or used in this state. If a contractor takes possession of materials in Texas that will be used in a lump-sum contract outside Texas, the

contractor must pay Texas state and local sales tax. However, if the vendor or common carrier delivers the materials to the out-of-state job site, no Texas sales tax is due.

If the materials purchased in Texas will be used in a separated contract, the contractor may issue a resale certificate in lieu of paying Texas tax.

Materials Purchased Outside of Texas for Use in Texas.

If materials are purchased from an out-of-state seller, the contractor must accrue and remit use tax on the materials unless the out-of-state seller collected Texas use tax or the material is purchased for a separated job, in which case the contractor may purchase it tax-free under a resale exemption.

This rule applies to include material that is purchased and processed out-of-state prior to being brought into Texas for use. Use tax is due on the cost of the incorporated materials.

Dirt, Sand and Gravel.

The sale and/or delivery of unprocessed dirt, sand, gravel or similar materials are not taxable. Materials are considered unprocessed if they have been merely sorted,

sized, screened, washed and/or dried. The sale of the same materials in a processed state (*i.e.*, crushed or mixed with other materials) is taxable.

As the end-user, a lump-sum contractor must pay tax to the seller on the purchase of processed dirt, sand and gravel. A separated contractor may issue a resale certificate instead of paying tax if the processed materials will be incorporated into real property.

Hauling Away Dirt. The charge attributable to hauling away excess dirt in conjunction with construction site preparation is not taxable.

Persons hauling dirt and similar unprocessed materials are considered to be performing a nontaxable service.

Agency Agreement. The Comptroller's office recognizes agreements between a contractor and a direct payment permit-holder allowing the contractor to serve as the agent of the permit-holder for the purpose of purchasing materials that will be incorporated into the realty under a contract between the contractor and the permit-holder. This assumes that the agreement so stipulates, that the contractor is allowed to issue purchase orders and direct payment exemption certificates to the material suppliers on the permit-holder's behalf, and to pay the permit-holder's bills.

Under this arrangement, both the agent and principal are liable for any taxes owed by the principal for purchases made under the agency agreement.

Agency agreements apply to materials incorporated into the job. The contractor must pay tax on consumable supplies, equipment and other taxable items used by the contractor in performing the construction contract.

Cement. The charge for cement is exempt from Texas sales tax.[61] Instead, cement is taxed to the cement producer under Chapter 181 of the Tax Code. The cement tax is imposed on a person who: (1) manufactures or produces cement in Texas or imports the cement into Texas and (2) distributes or sells the cement in intrastate commerce or uses the cement in Texas. The cement tax is based upon on the amount of cement distributed, sold, or used by the person for the first time in intrastate commerce. The tax applies to only one distribution, sale, or use of cement.

Ready-Mix Concrete. Ready-mix concrete is a taxable manufactured product. Because ready-mix is processed with special equipment while being transported, the seller delivers the product to the buyer's job site. The seller should collect sales tax based on the total charge, which includes any transportation or delivery fee.

All transportation and delivery charges by a ready-mix company are part of the total charge for the product and thus taxable.

Charges for transportation and delivery by someone other than the ready-mix company are treated as non-taxable services. These non-taxable services include the use of pumps and similar equipment to move the ready-mix from the seller's delivery trucks to the customer's forms.

Supplies or "Consumables"

Supplies or "consumables" are items consumed at the construction site. "Consumed" means that after being used for its intended purpose, the item is completely used up or destroyed.[62]

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61 Texas Tax Code § 151.308(a)(3).

62 *Cf.* Texas Tax Code § 151.311(d).

Contractors are generally (but not always) required to pay tax on their purchases of their supplies when they buy them. "Consumables" include such things as:

- masking tape,
- corrugated cardboard,
- paint pot liners,
- steel strapping,
- sandpaper,
- trash can liners,
- non-reusable concrete forms,
- non-reusable drop cloths,
- barricade tape,
- natural gas, and
- electricity.

Example

Alpha Construction enters into a lump-sum contract to build a 10-story office building. Alpha Construction purchases disposable drop cloths. The drop cloths are consumable supplies the charges for which are subject to sales tax.

Consumables do not include items that are incorporated into realty, such as mortar, bricks, nails, and caulk. Items incorporated into realty are considered materials. Consumables also do not include items attached to equipment as accessories, such as:

- saw blades
- drill bits
- grinding disks
- cutting stars

Incorporated materials are attached to or incorporated in the realty and become a part of the property. Welding illustrates this point.

Example

Welding rods and welding gas illustrate the difference between materials and supplies. Welding rods are incorporated materials. When welding, the welding rod is melted into the joint in a building's structural steel and thus becomes incorporated into the realty. On the other hand, the welding gas is a supply. The gas used to heat the rod and make the weld is consumed in the process of welding, and so it is not incorporated into the realty.[63]

While consumables used in construction are usually taxable, there is an exception that can apply when the contractor provides non-taxable services under a separated contract that specifically states that title to the consumables will pass to the customer upon receipt of the items by the contractor, and if no use of the items is made by the contractor prior to passage of title to the property to the customer.[64]

Example

Alpha Construction enters into a separated contract to build a 10-story office building. The contact states that title to consumables transfers to the customer upon receipt by Alpha Construction. Alpha Construction purchases and receives drop clothes to use when painting. Alpha Construction may give a resale certificate for the charge for the drop clothes and collect tax on the separately-stated price for them from its customer.

Also, when the contractor accepts an exemption certificate in good faith from qualifying exempt entities, the contractor can issue an exemption certificate for consumable items used in the performance of a contract if the consumable is:

- necessary and essential for the performance of the contract; and
- completely consumed at the job site.

Nonexempt Customers. Both lump-sum and separated contractors improving real property belonging to nonexempt customers must pay tax on consumables at the time of purchase.

When the customer reimburses the contractor for consumables, the transaction is not taxable. If the contractor charges the customer tax on consumables, the tax – collected in error – should be remitted to the state. The state will refund the tax collected in error to

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63 Comptroller Letter No. 200904300L (April 6, 2009).

64 Comptroller Rule 3.291(b)(2)(B).

the contractor once the contractor has issued either a refund to the customer or, if the customer accepts it, a credit memo for the tax amount.

Equipment

Contractors must pay tax on all machinery and equipment that they purchase, lease, or rent for use in making real property improvements. Equipment includes items such as cranes, forklifts, bulldozers, and similar items.

> *Example*
>
> ABC Contractors purchases a diesel-powered backhoe, which it uses to dig trenches. ABC Contractors owes sales tax (and the TERP surcharge) on the purchase price of the backhoe, including costs billed by the seller of the backhoe for transporting it to ABC Contractors' yard.

Moveable Specialized Equipment vs. Motor Vehicle. Moveable specialized equipment is a unit designed and built specifically to perform a specialized function that does not include transporting a passenger or property separate from itself. These types of equipment are not typically designed to operate on public highways. The Comptroller's rule provides examples of moveable specialized equipment:

> motorized cranes; motorized oil well servicing units; and mobile car crushers.[65]

A motor vehicle is a self-propelled unit designed to transport persons and separate property upon the highway.[66] A motor vehicle is defined to include a trailer designed to transport separate property. The definition of a motor vehicle also includes a conventional cab chassis with equipment attached. It does not lose its identity as a motor vehicle when equipment is attached.

Taxability. Purchases of moveable specialized equipment or machinery are subject to limited sales or use tax. The county tax assessor-collector is not responsible for determining whether limited sales or use tax has been paid on a unit.

Leases

The bare lease of tangible personal property is subject to sales tax if an outright sale of the underlying property would be subject to sales tax. This is because a sale or purchase includes a transaction in which a transfer of title or possession of tangible personal

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65 Comptroller Rule 3.88(a)(3).

66 Comptroller Rule 3.88(a)(2).

property occurs. The statute specifically provides that the lease or rental of tangible personal property is taxable.[67] A lease is defined as a transaction in which possession but not title to tangible personal property is transferred for consideration. Only leases or rentals of tangible personal property (*e.g.* equipment) are taxable. Leasing or renting real property (*e.g.* buildings or land) is not taxable. In the case of taxable leases, the issue is when must the sales tax be paid, how much, and by whom. The answer depends upon the type of lease.

Operating Leases

Under a true lease (called an "operating lease"), sales tax is imposed during the period in which the rental receipts are considered income under the lessor's method of accounting.

Example

Delta Construction leases a power washer from A-Z Rental for $100 per month. Delta Construction owes sales tax each month on this $100 and must send it with its monthly lease payment.

Sales tax is based on the amount of each lease payment received by the lessor including interest charges unless it is shown that they relate to late payments or other defaults under the lease, whether or not separately-stated. Assigning the lease contract will trigger immediate payment of all sales & use tax due on any remaining lease payments.

☞ ***Caution:*** Payments must represent a fair rental market value. Manipulating lease terms to avoid the leasing tax rules will not work. In a contested hearing, the taxpayer entered into a lease agreement to lease pull units and drilling rigs from an affiliated entity.[68] The taxpayer argued that the transaction was not a lease because the consideration exchanged between the parties did not equal the fair market value of the leased items.

The Comptroller held that the validity of a lease does not turn on the profitability of the leases, but rather, the controlling requirement is that the transfer of possession to the lessee must be accompanied by an exchange of consideration. Although the consideration exchanged between the parties was less than market value in this case, the agreement was still considered a taxable lease.

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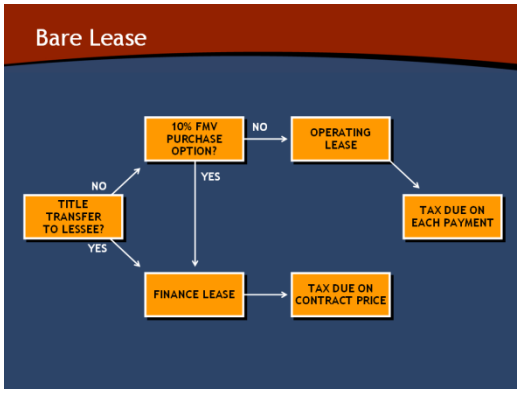
67 Texas Tax Code §151.005(1) & (2).

68 *See* Comptroller Hearing No. 110,461 (July 8, 2015).

Financing Leases

A financing lease constitutes the disguised sale of the property. A financing lease occurs when the lease contract contains (1) a provision that title to the property must be transferred at the end of the lease or (2) an option to purchase the property for a nominal price at the end of the lease (a price is considered nominal if it is estimated, at the time the contract is executed, to be less than ten percent (10%) of the property's fair market value when the option is exercised). Other circumstances may also apply which would create the presumption of the existence of a financing lease.[69]



A financing lease is treated as a taxable sale. Tax is due when the buyer takes possession of the property or when the first payment is due, whichever is first.[70] If the lessee receives the property in Texas, sale tax is due on the total amount of the contract, regardless of where the property is used during the lease. If the lease is made with an out-of-state lessor, the Texas lessee must accrue use tax.

Generally, a lessee owes use tax when the lessee signs a lease from an out-of-state lessor for property to be used in Texas. Property brought into Texas for use under either a financing lease or an operating lease is presumed to be subject to use tax. A credit is available for sales & use taxes paid to another state. An exception to imposing the Texas use tax applies if the property is used for more than one year outside Texas. In that case, when the leased property is brought into the state, no use tax is presumed to be due. The exemption for occasional sales does not apply to the rental or lease of taxable items.[71]

Operator Leases

The tax laws treat equipment leased with an operator (an "operator lease") differently than equipment leased without an operator. The latter is considered the lease of tangible personal property. The former is generally considered the performance of a service, which

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69 Comptroller Rule 3.294(a).

70 Comptroller Rule 3.294(f)(3)(B).

71 Texas Tax Code § 151.304(e).

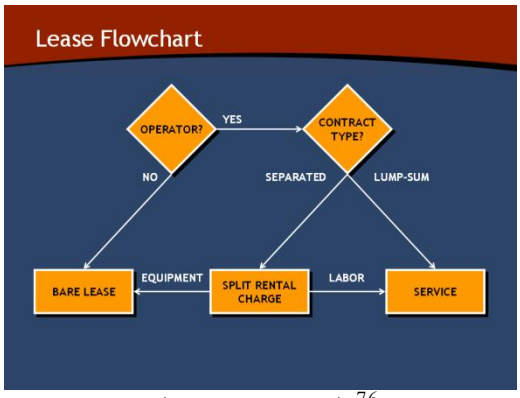
may or may not be taxable depending upon the nature of the service being performed (such as the repair or remodeling of commercial real property).[72]

Who is an Operator?

An operator is a person who actively guides, drives, pilots, or steers the equipment.[73] Installation, supervision, and disassembly are non-taxable services when provided on a stand-alone basis. However, they do not represent activities of operational control and charges for them are taxable as part of the rental charge.[74]

Lump-Sum v. Separated Leases

Operator leases are further broken down into two categories: If the lessor's contract charges its customer a lump-sum price (one charge for both equipment and operator), then the entire charge is treated as compensation for the *service* provided. If, on the other hand, the lessor's contract separately states the charge for the operator from the charge for the equipment, then the charge for the equipment becomes a taxable lease of *tangible personal property* regardless of the operator charge.[75]



When a lessor bills an operator lease on a separated basis, the billing must properly allocate separate charges for labor and equipment. In other words, the lessor must be sure that the charge for the equipment is reasonably close to the fair market rental value of the equipment. The Comptroller may disallow an unreasonably low charge for equipment in lieu of an unreasonably high operator charge (presumably to reduce sales tax liability on the equipment lease portion).[76]

The Comptroller also treats other lease charges as taxable. For example, the Comptroller considers separately-stated charges for labor or services rendered in installing, servicing,

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72 Comptroller Rule 3.294(c)(1) & (2).

73 Comptroller Hearing No. 44,231 (2007) (STAR No. 200711048H).

74 *Combs. v. Chevron, Inc.*, 319 S.W.3d 836 (Tex. App.—Austin 2010, pet. denied).

75 Comptroller Rule 3.294(c)(3).

76 Comptroller Rule 3.294(c)(3)(A).

maintaining, repairing, supervision, set-up, hook-up, assembly, disassembly, erection and dismantling to be a part of the lease price, and hence taxable.[77]

Operational Control

An issue often arises when property, such as equipment, is leased and accompanied by someone from the rental company. The issue is whether the rental company is providing a service or renting taxable property.

The issue first surfaced in the case of *Davis-Kemp Tool Co. v. Bullock*.[78] There, Davis-Kemp provided fishing services for oil well drillers and producers. Davis-Kemp maintained a fishing tool warehouse where it stored tools on behalf of its suppliers. When a customer needed fishing services, Davis-Kemp workers would remove the appropriate tool from its warehouse and use it to retrieve the stuck pipe or other item lodged in the well bore.

Davis-Kemp sent invoices to its customers containing separately-stated charges for the rental of the tool and the services of Davis-Kemp's workers who operated the tool. Davis-Kemp charged and collected sales tax on the tool rental charge. Under its agreement with its suppliers, Davis-Kemp paid them one-half of the amount collected from its customers for the tool rental. Davis-Kemp provided its suppliers with resale certificates in lieu of paying sales tax on the charges for the tool rental.

The Comptroller disputed Davis-Kemp's classification of the tool rental charges on its invoices. The Comptroller alleged that Davis-Kemp's customers did not owe sales tax on the rental charge, but instead Davis-Kemp should have paid it on the amounts Davis-Kemp paid the suppliers for the use of the tool.

The court agreed with the Comptroller reasoning that Davis-Kemp had not rented the fishing tools to its customers because it never transferred operational control of the tools to the customers. Instead, the fishing tools were used by Davis-Kemp workers to perform their services (taxable or nontaxable depending upon the nature of the fishing services provided).

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77 Comptroller Rule 3.294(d)(1) & (4).

78 584 S.W.2d 579 (Tex. Civ. App.—Beaumont 1979) *aff'd,* 590 S.W.2d 708 (Tex. 1979).

In *Combs v. Chevron, Inc.*,[79] Chevron hired contractors to install temporary scaffolding at one of its refineries to allow it to perform maintenance work on structures at the refinery. The contractors provided the scaffolding materials, built the scaffolds, monitored them for safety, and dismantled them when the job was complete. Chevron employees and other contractors Chevron hired used the scaffolding to perform the maintenance work. The Third Court of Appeals found that the "essence of the transaction" was the rental of the scaffolds, which are tangible personal property, because Chevron primarily sought use of the scaffolds so Chevron and not the scaffolding company could perform maintenance work. Since Chevron held operational control of the scaffolding by performing maintenance work, the Court considered Chevron the lessor of the scaffolding structure and not the consumer of non-taxable services provided by the scaffolding company.

Taxable Services - Generally

Construction-related services may or may not be taxable under the sales & use tax laws.[80] Certain categories of construction-related services are not taxable at all. This discussion pertains only to the common services classified as taxable, as they relate to contractors and repairmen.

It's important to understand which services the tax laws classify as taxable. Taxable service providers are required to collect sales tax from their customers. They may purchase items under a resale exemption if they transfer care, custody, and control of the items to their customers. In contrast, providers of non-taxable services must pay tax on all of their purchases, including items transferred, equipment and supplies, unless they separately state the charge for the transferred items and collect tax on them.

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79 319 S.W.3d 836 (Tex. App.—Austin 2010, pet. denied).

80 The official name is: The Texas Limited Sales, Excise and Use Tax and is found in Texas Tax Code §§ 151.001 *et seq.*

Services are only subject to sales & use tax if they are included on the statute's list of seventeen (17) taxable services.[81] Generally, the following taxable services are prevalent in the construction industry: tangible personal property repairs, remodeling, maintenance and restoration; real property repairs and remodeling; real property services; insurance services; information services; data processing services; security services and telecommunication services.

This course focuses on those services that most commonly affect the construction industry. While other taxable service categories exist and may apply to transactions conducted in the construction industry, this course only discuss the core taxable services that contractors and repairmen will routinely encounter.[82]

Common Rules

The Texas Tax Code and applicable Comptroller rules provide common rules for most types of taxable services. We discuss them below and follow them with separate discussions of the individual categories of taxable services frequently performed in the construction industry.

Sales Price of Taxable Services. The total amount charged for a taxable service is subject to sales tax. This includes charges for labor, materials, overhead, transportation and profit, regardless of whether such charges are separately identified to the purchaser of the service.[83]

81 *See* Texas Tax Code § 151.0101. Services on this list may nevertheless be nontaxable if their taxation is prohibited by other law, such as the federal Internet Tax Freedom Act.

82 The remaining taxable services include amusement, cable TV, debt collection, credit reporting, insurance services, internet access, motor vehicle parking and storage, security, personal services, telecommunications, and telephone answering.

83 Texas Tax Code § 151.007(a).

Example

XYZ Machine Repair Company sends a repairman to fix ABC Contractor's paint compressors. XYZ charges $100 per hour plus out-of-pocket travel. The entire charge, including travel costs, is subject to sales tax.

Property Used to Provide Services. The tax laws treat a person performing either taxable or non-taxable services as the consumer of machinery, equipment, and supplies used in performing the service. As the consumer, the service provider owes sales tax on the sales price of the machinery, equipment, supplies, etc. used in the service.

Example

Dallas contractors purchases a used compressor to use in repainting the interior of office buildings, federal buildings, and new homes. The sales tax laws treat Dallas Contractors as the consumer of the compressor and it owes sales tax on the full purchase price.

Taxable Services and Items Transferred. Persons who provide taxable services may issue resale certificates for the charges for their purchases of materials and taxable services if the service provider transfers care, custody and control of the item to its customer.

Sharp v. Clearview Cable, Inc.[84] Clearview installed equipment such as antennas, down converters and connecting wire outside the homes of its subscribers. Clearview had purchased the equipment tax-free under a resale exemption. The Comptroller challenged Clearview's right to the exemption for the outside equipment and lost. The appeals court held that Clearview was entitled to the resale exemption because it had transferred care, custody and control of the equipment to its subscribers.[85]

Employee Services Exempt. The services performed by a business's own employees are exempt.[86] The sales tax laws don't require taxpayers to determine the portion of time their employees spend performing taxable services and impute a value to the services to be taxed. The employee services exemption also applies in the case of temporary help services.

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84 960 S.W.2d 424 (Tex. App.—Austin 1998, pet. denied).

85 960 S.W.2d 424 (Tex. App.—Austin 1998, pet. denied).

86 Texas Tax Code § 151.057.

Example

Property Management Services hires workers to mow the grass and handymen to make repairs. Both services are listed as taxable under the Tax Code. However, since employee labor is exempt from the sales tax, Property Management Services does not owe sales tax on its employees' services.

Temporary Help. The taxable services provided by employees of a temporary help service[87] are exempt if the temporary employees are hired to supplement the employer's existing work force, if the service is normally provided by the employer's own employees, all the supplies and equipment necessary are provided by the employer, and the temporary employees are supervised directly by the employer.[88]

Example

Property Management Services contracts with "Born to Mow" to provide grass mowing workers for two weeks while its mower employees are on vacation. The contract service provided by "Born to Mow" is exempt from sales tax if Property Management Services supervises and provides all of the equipment and supplies for the mowing.

PEO Arrangements (formerly Leased Employees). A professional employer organization (formerly called "staff leasing company") hires a client company's employees and then leases them back to the client company. This arrangement relieves the client company of the paperwork burdens associated with maintaining personnel, including payroll and benefits.

Texas law exempts taxable services performed by covered employees if:

- at least 75% of the assigned employees providing services under the professional employer organization were previously employees of the client company for a period of

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87 The temporary employment service must meet the criteria set forth in Section 93.001 of the Labor Code. *See* Texas Tax Code § 151.057(2).

88 Texas Tax Code § 151.057; *Allstate Ins. Co. v. Hegar*, 484 S.W.3d 611 (Tex. App.—Austin 2016, pet. denied).

at least three months immediately before the start of the professional employer organization;

- none of the covered employees were employed previously by the company providing professional employer organization services under the contract unless the previous employment was through a shared employment relationship or by an entity that previously provided or currently provides taxable services to the client company; and
- a shared employment relationship exists between the client company and the professional employer organization as to the covered employees. [89]

There are exceptions and special rules for companies that have been in business less than three months.

Reselling Services. A service provider may accept a resale certificate for a taxable service only if the customer intends to transfer the service as an integral part of the taxable services it is providing to its client.[90] A service is an integral part of the taxable services provided only if it is essential to the performance of the taxable service and without which the taxable service would not be rendered.

Example

General Contractor is hired to remodel a small office building. General Contractor hires HVAC contractor to install a new HVAC systems and ductwork. HVAC is performing a taxable remodeling service. General Contractor may give HVAC a resale certificate, in lieu of paying sales tax to HVAC, because General Contractor will "resell" HVAC's services when General Contractor charges the office building owner for the remodeling work and collects tax on the full remodeling charge.

89 Texas Tax Code § 151.057.

90 Texas Tax Code § 151.006(a)(1).

Services Incorporated into Taxable Property. A buyer may issue a resale certificate if the buyer intends to incorporate the entire taxable service into tangible personal property that will be resold.[91]

Example

ABC buys used furniture for resale. ABC hires a repair company to restore and refinish the furniture before ABC resells it. ABC may issue a resale certificate to the repair company.

Services Performed on Exempt Personal Property. A service that is performed on tangible personal property that, if sold, leased or rented, at the time of the performance of the service, would be exempt from sales tax because of the nature of the property, its use, or a combination of both, is exempt from sales tax. Even if the item was not exempt when it was originally bought, if it qualifies as exempt when the taxable services are performed, then the taxable services are exempt.

Installation Labor. Installation is labor to place tangible personal property in position, without changing its form, where it will reasonably accomplish the purpose for which it was purchased.[92] Charges for installation connected with the sale of tangible personal property are taxable.[93] However, the charge for installation, connected with the sale of tangible personal property that becomes a permanent improvement to realty, is taxable when it is part of the charge to repair or remodel nonresidential real property.[94] The charges by a third party for installing an item sold by another person are not taxable.[95] Separately-stated charges for supervising the installation of tangible personal property made by someone other than the seller of tangible personal property are not taxable.[96]

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91 Texas Tax Code § 151.006(a)(1).

92 *See* Comptroller Letter No. 200107420L (2001).

93 Texas Sales Tax Policy & Procedures Manual (Nov. 1993).

94 *See* Comptroller Rule 3.354(a)(2); *see generally* Comptroller Rule 3.357.

95 Texas Sales Tax Policy & Procedures Manual (Nov. 1993); *See* Comptroller Hearing No. 32,417 (1994).

96 Texas Sales Tax Policy & Procedures Manual (Nov. 1993).

Fabrication Labor. "Fabrication" means "to make, build, create, produce, or assemble components of tangible personal property, *or to make tangible personal property work in a new or different manner.*"[97] Fabrication of tangible personal property is subject to sales tax.[98]

The Comptroller has held in some circumstances that labor for installing equipment is properly classified as fabrication labor rather than installation labor.

In Comptroller Hearing No. 32,417 (1994), a taxpayer argued that charges for labor to install refrigeration cases, compressors, and condensers in two of the taxpayer's grocery stores during the remodel and expansion of those stores were not taxable because they were charges for installing tangible personal property by a third-party installer. These were large refrigeration cases that were bolted together, bolted to the floor, and also connected by copper tubing that was run through the store's ceiling and to the electrical source. The Comptroller held that the taxpayer assembled the components of the tangible personal property (the refrigerator system) when it set in place and bolted together the refrigeration cases, placed compressors in the mezzanine areas and the condensers on the roofs of the building, and then interconnected these component parts of the system with copper tubing to make the system. Additionally, "the labor performed by Company ABC caused the individual components to operate in a new or different manner as a refrigerator system." So, the charges were taxable as fabrication labor.

Assembly Labor. Assembly labor is the labor to connect component parts into a finished product.[99] In general, assembly and reassembly services are not taxable.[100]

However, under Comptroller Rule 3.300(a)(5), fabrication is an act of manufacturing, and the definition of fabrication includes the assembly of components of tangible personal property.[101] Therefore, it is the Comptroller's policy that initial assembly is the final act of manufacturing tangible personal property and should be taxed in a manner consistent with the sale of the tangible personal property.[102]

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97 Comptroller Hearing No. 32, 417 (1994) (emphasis added); 34 Tex. Admin. Code § 3.300(a)(5).

98 Comptroller Hearing No. 32, 417 (1994) (citing to Tex. Tax Code §§ 151.005(4), 151.009, 151.010, 151.051, and 151.054).

99 *See* Comptroller Letter No. 200107420L (2001); Comptroller Letter No. 9809831L (1998) (Assembly includes putting components together to make a finished product).

100 *See* Texas Tax Code § 151.0101.

101 *See* Comptroller Rule 3.300(a)(5);

102 *See* Comptroller Hearing No. 24,478 (1989); Comptroller Hearing No. 40,286 (2006).

Charges for dismantling, moving and reassembling tangible personal property that was in final form are akin to a moving service and are nontaxable.[103]

Taxable Services Affecting the Construction Industry

Real Property Services

This category is different than real property repairs. The tax on real property services applies to both commercial and residential services, as contrasted with the tax on real property repairs, which applies only to non-residential services. The types of taxable real property services are:

Garbage Collection. Waste removal is a taxable service, although Texas exempts fees paid for the removal of industrial solid waste from sales tax. Industrial solid waste includes the solid waste resulting from or incidental to a process of industry, manufacturing, mining or agricultural operations.[104] Texas also exempts fees paid for the removal of hazardous waste from sales tax.[105]

Industrial Solid Waste. By rule, the Comptroller provides that those claiming the exemption from sales & use tax for charges for removing industrial solid waste "may use any reasonable allocation" between waste subject to tax and exempt industrial solid waste that "is supportable by books and records."[106] The Comptroller interprets this rule to require a contemporaneous, precise, objective record, which the Third Court of Appeals upheld in *Southern Plastics, Inc. v. Combs*.[107] In its decision, the Third Court of Appeals cited a Comptroller letter stating that taxpayers who generate industrial solid waste could use their knowledge of their business processes to create this record by "identifying and documenting in writing those processes that produce the various types and amounts of wastes."[108] For example, a manufacturer who determines that it generates 100 pounds of

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103 Texas Tax Code § 151.0101; *see also* Comptroller Letter No. 8909L0958G01 (1989).

104 Texas Health and Safety Code, Ch. 361.

105 Texas Tax Code § 151.0048(a)(3)(C).

106 Comptroller Rule 3.356(h).

107 No. 03-08-00149-CV, 2009 WL 1896077 (Tex. App.–Austin 2009, no pet.).

108 No. 03-08-00149-CV, 2009 WL 1896077 (Tex. App.–Austin 2009, no pet.) (citing Comptroller Letter No. 200104170L).

office waste per week, 100 pounds of packaging waste per week, and 200 pounds of industrial solid waste from manufacturing each week could show that 50 percent of its waste is exempt industrial solid waste. The Comptroller states that the taxpayer could further support this record with photographs showing the amount of types of waste it generates.[109]

Asbestos Removal. *Rylander v. Associated Technics Co., Inc.* held that the Comptroller could not reclassify the exempt charge for removing asbestos as a taxable repairs and remodeling service.[110] Associated Technics ("AT") provided asbestos removal services. AT removed asbestos from buildings, cleaned the debris from the buildings, and disposed of the asbestos material. The Comptroller claimed that a portion of AT's charge for performing these services was taxable.

The Comptroller agreed that disposing of the asbestos material was not a taxable service because it involved removal of a hazardous substance. However, the Comptroller argued that removing the asbestos from the walls of commercial buildings was taxable as real property repair and remodeling.

The court disagreed and ruled in favor of the taxpayer. It noted that under the Tax Code, removing hazardous waste is specifically exempt from being a taxable real property service. In light of this specific exemption, the court held that the same activity cannot also be subject to tax under another broad definition of taxable services, such as the definition of real property repair and remodeling. The court refused to treat AT's services as two standalone services – removing the asbestos from the walls and hauling the asbestos to the landfill. Instead, the Court viewed all of AT's activities as parts of a continuous process, the goal of which was to remove hazardous waste.

Mold Removal. The removal and disposal of mold is a taxable service because mold is not hazardous waste. According to the decision, mold is not hazardous waste because federal and state solid waste disposal laws do not classify mold as hazardous waste, and no special disposal requirements exist for mold.[111]

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109 No. 03-08-00149-CV, 2009 WL 1896077 (Tex. App.—Austin 2009, no pet.) (citing Comptroller Letter No. 200104170L).

110 *Rylander v. Associated Technics Co., Inc.*, 987 S.W.2d 947 (Tex. App.—Austin 1999, no pet.).

111 Comptroller Hearing No. 45,021 (May 27, 2008).

Servicing Portable Toilets. A Comptroller hearing decision held that servicing portable toilets is the nontaxable removal of human waste where the service does not include the rental of the toilets, which are tangible personal property.[112]

Landscaping. Landscaping means arranging and modifying areas of land, natural scenery and other areas (such as indoor or outdoor patios) for aesthetic effect. It is taxable. Landscaping does not include the addition of sprinkler systems, retaining walls, ponds, pools or fences.[113]

Erosion Control Services. The Comptroller takes the position that various erosion control services constitute the sale of tangible personal property, taxable landscaping or the taxable rental of tangible personal property. For example, the Comptroller has ruled that payments for silt fencing used in erosion control projects are taxable rentals of tangible personal property, even though the silt fencing is either discarded or remains with and becomes part of the land.[114]

Lawn and Yard Maintenance. Mowing, trimming, fertilizing, watering and any other treatment or service that may be performed on private or commercial yards or lawns is taxable. It includes maintenance of trees and plants, whether inside or outside a building. The term does not include activities such as clearing land for buildings, power line rights-of-way, pipeline rights-of-way, or maintenance on land belonging to a governmental entity when the service is required by the governmental entity.[115]

Grounds Cleaning. Residential or nonresidential building or grounds cleaning, janitorial or custodial services are taxable.[116] Cleaning, janitorial and custodial services may cover services that might otherwise be characterized as non-taxable real property maintenance, such as light bulb replacement and other minor repairs. However, they would not include major repairs or alterations, such as room painting or wallpapering.

According to the Comptroller, taxable cleaning, janitorial, and custodial services do not include power washing and similar cleaning services when performed on improvements to

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112 *Compare* Hearing No. 38,868 (August 6, 2003) (holding that separate charges for servicing toilets were nontaxable) *with* Hearing No. 38,774 (holding that rental payments for portable toilets at home construction sites were taxable rentals of tangible personal property).

113 Comptroller Rule 3.356(a)(4).

114 Comptroller Letter No. 200309150L (Sept. 18, 2003).

115 Comptroller Rule 3.356(a)(5).

116 Comptroller Rule 3.356.

realty other than a building (or its components), building grounds, and parking lots. The Comptroller subjects these services to sales tax only when performed by the same person in connection with another taxable service, such as painting or making repairs to the property.[117]

Construction Site Clean-Up. A contractor may issue a resale certificate in lieu of paying tax on charges for the **final** clean-up of a construction site. The Comptroller considers this a service resold to the customer. Contractors must collect tax from their customers on charges for this service. However, a contractor must pay sales tax on charges for the **daily** clean-up of a construction site, because the Comptroller considers the contractor the consumer of this service.[118]

Pest Control Services. Pest control services are subject to sales & use tax unless they are purchased by a contractor "as part of the improvement of real property with a new structure to be used as a residence or other improvement immediately adjacent to the new structure and used in the residential occupancy of the structure.".[119] This includes identifying, preventing, controlling, or eliminating:

- the infestation insects, spiders, mites, ticks, ants, bees, and other related pests, wood infesting organisms, rodents, weeds, nuisance birds, or any other obnoxious or undesirable animals which may infest households, railroad cars, ships, docks, trucks, airplanes or other structures or their contents;
- pests or diseases of trees, shrubs or other plantings in a park or adjacent to a residence, business establishment, industrial plant, institutional building, or street; and
- related activities, such as inspection or evaluation concerning the nature or extent of an infestation; reports; or performance of services to control pest or insect infestation.

The charge for the service is taxable whether chemicals or mechanical devices are used.[120]

Home Staging Services. Home stagers enhance homes for sale by minimizing the homes' flaws. Home staging services include depersonalizing and uncluttering, landscaping, power washing and cleaning, and performing minor home repairs and remodeling. Depersonalizing, uncluttering, and repair and remodeling of residential real property are

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117 Comptroller Letter No. 200712999L (December 6, 2007).

118 Comptroller Letter No. 200602552L (February 16, 2006).

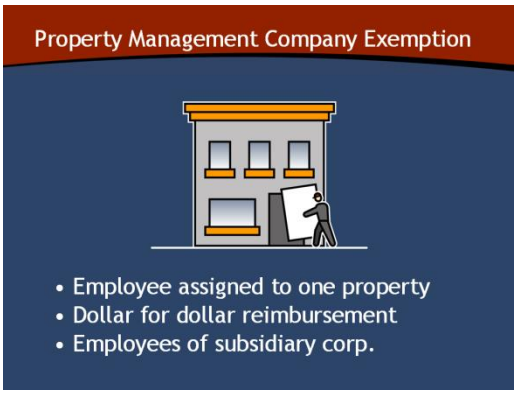
119 Texas Tax Code § 151.0048(b).

120 Comptroller Rule 3.356(a)(8).

nontaxable services. Landscaping, power washing, and cleaning are taxable real property services.[121]

Surveying. For surveying services, the issue of taxability generally turns on boundaries. Taxable services include those performed to determine or confirm the real property boundaries, or to determine or confirm the location of structures or other improvements in relation to the boundaries of the property. The service involves the use of relevant elements of law, research, measurement, analysis, computation, mapping and land description. Taxable surveying includes boundary recovery, residential surveying, lot surveying, title surveying, as-built title surveying, and right-of-way surveying. Activities performed after taxable surveying has been completed to search the surveyed area for items of archaeological or historic significance are not taxable.[122]

Property Management Companies. Property management companies often provide services for property owners that constitute real property services.[123] Otherwise taxable services performed by employees of a property management company are not taxable if the employee is permanently assigned to one rental property and the property manager is reimbursed by the property owner on a dollar-for-dollar basis for that employee's salary.[124]



121 Comptroller Letter No. 200902268L (February 17, 2009).

122 Comptroller Rule 3.356(a)(9).

123 Taxable services include: collecting garbage; hauling trash; landscaping; lawn and yard maintenance; building or grounds cleaning; janitorial; or custodial services; pest control; real or tangible property repairs, remodeling; and security services.

124 Comptroller Rule3.356(n)(1).

Example

Apartment City Management Company employs Dale Jones to perform landscaping services at the Leon Creek Apartments. Apartment City pays Mr. Jones a monthly salary of $4,000. The property owner reimburses Apartment City $4,000 each month for Mr. Jones' salary. Mr. Jones' real property landscaping services are not taxable in this instance.

Subsidiaries. Property management companies may create and use specialized subsidiaries to perform services at the rental property. Otherwise taxable services performed by a subsidiary of a property management company are exempt if the subsidiary bills the property owner on a dollar-for-dollar basis.

Holiday Decorating. Charges to decorate a tree or home for the holidays are not taxable unless the decorator also sells or rents the decorations to the customer.

Late Fees. Late rental fees that an owner of residential property receives from a tenant are generally considered nontaxable interest charges rather than taxable debt collection charges. However, if a property management company receives specific extra compensation for collecting delinquent accounts, that extra compensation is taxable to the property owner. [125]

Commercial Property Repairs and Remodeling

Labor charges incurred for commercial real property repair, remodeling and restoration is a taxable service.[126] Commercial structures are non-residential real property structures where people generally do not live 30 consecutive days or more. They include office buildings, warehouses, stores, theaters, roads, oil wells, golf courses, hospitals, prisons, and so forth. Remodeling is making over, rebuilding, replacing, or upgrading existing real property. Repair means to mend or bring back as near as can be to its original working order real property that was broken, damaged or defective. Restoration is an activity performed to bring back as near as can be to its original condition real property, which is still operating and functional, but that has faded, declined or deteriorated.

We dedicate an entire chapter to a discussion of these services in Chapter VI.

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125 Comptroller Letter No. 200002072L (Feb. 24, 2000).

126 Comptroller Rule 3.357.

Personal Property Repairs and Remodeling

The charges for services to repair, restore, remodel, or maintain most tangible personal property are subject to Texas sales & use tax. This applies to all types of tangible, personal property except aircraft;[127] water transportation vessels (except certain pleasure vessels); motor vehicles; and computer programs that are sold by someone other than the service provider (includes software development and modification).[128]

The Texas Tax Code imposes the sales tax on the entire charge for materials, parts, labor, consumable supplies, equipment, and any charges connected to the repair, remodeling, restoration or maintenance service.

Charges for repairing items that if purchased today would be exempt from tax are also exempt.

> *Example*
>
> Mr. Smith purchases a hot tub from ABC Hot Tub Dealer under a medical prescription. If the exemption is properly claimed, repairs to the hot tub are also exempt.

Environmental Repairs. Texas law exempts labor charges (not materials) for repairing, remodeling, maintaining, or restoring tangible personal property if required by state or federal law in order to protect the environment or conserve energy.[129] Labor charges for these exempt repairs must be separately-stated from any charges for non-exempt repairs and materials.[130]

Items Consumed During the Repairs. A service provider may purchase for resale materials that will be transferred to the care, custody and control of the customer.[131] However, a service provider must pay sales tax on his purchases of supplies, tools, machinery and

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127 Comptroller Rule 3.292. The Comptroller requires contractors who remodel aircraft under lump-sum service contracts to pay sales tax on the purchase price of materials incorporated into the aircraft. The Comptroller's position is that the contractor may not charge sales tax to the customer, even if the customer is a dealer who is remodeling the aircraft for resale. *See* Comptroller Letter No. 200208398L (Aug. 30, 2002).

128 Comptroller Rule 3.292.

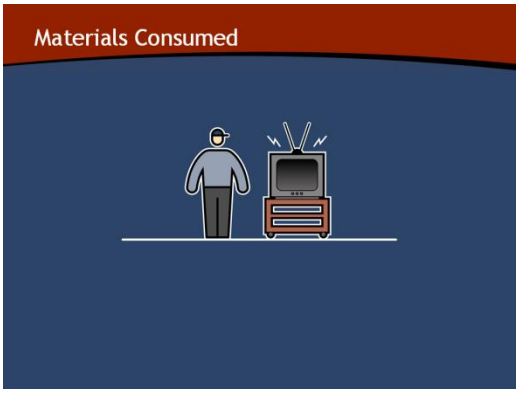
129 Texas Tax Code § 151.338.

130 Comptroller Letter No. 201009943L (Sept. 21, 2010) (superseded on other grounds).

131 *Sharp v. Clearview Cable TV, Inc.*, 960 S.W.2d 424 (Tex. App.—Austin, 1998).

equipment that are purchased for use in performing the repair and are not transferred to the customer.

Example



A TV repair person services a broken television set. In the course of repairing the set, the repair person must purchase a new electronic transistor, a soldering gun and some solder. The repair person may purchase the transistor from his or her supplier tax-free by issuing a resale certificate. The care, custody and control of the part will be transferred to the customer at the time of the repair. On the other hand, the repair person may not purchase the solder or the soldering gun tax free. The gun will be retained by the repair person. The solder itself (although the care, custody and control of it may technically be transferred to the customer) will be *consumed* during the repair and will not be in any usable condition separate and apart from the repair. The customer will owe sales tax on the entire charge for the parts and labor.

Warranties. Whether or not sales tax is due depends on the type of warranty. No tax is due on parts or labor furnished by the manufacturer to repair tangible personal property under a manufacturer's warranty. The rationale is that the consumer already paid sales tax on the manufacturer's warranty as a component of the item's sales price. The definition of "sale" or "purchase" includes charges for extended warranties or service contracts for the performance of a taxable service.[132] Extended warranties represent pre-payments for taxable repairs to tangible personal property.

Sales tax is due on the sale of an extended warranty, service contract or service policy. The repairperson performing the service must collect tax on any charge to the owner for labor or parts not covered by the extended warranty. The repairman may issue a resale certificate when purchasing parts.

Warranty Contracts Covering Only Residential Real Property.[133] Residential real property repair is not a taxable service, and the charge for a warranty contract covering only

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[132] Texas Tax Code § 151.001(3).

[133] *See* Comptroller Letter Memo No. 201701001L (January 25, 2017).

residential real property repair is not taxable. The seller of a warranty contract covering residential real property should not collect tax on the sales price of the warranty contract or on any subsequent fees the purchaser must pay under the warranty contract, including diagnostic fees, service fees, and trip charges.

Whether the seller of a warranty contract covering residential real property owes tax on the purchase of residential real property repairs depends on the terms of the contract between the seller and the third-party consumer. If the contract is for a lump-sum charge, then the lump-sum charge for the residential real property repair is not taxable.

But, if the contract separately states amounts for repair labor and incorporated materials, then the seller of the warranty contract must collect tax on the separate charge for incorporated materials.

Warranty Contracts Covering Tangible Personal Property and Real Property.[134] The seller of a warranty contract covering both real and tangible personal property for a lump-sum charge should not collect tax on the sales price of the warranty contract at the time of sale or on any subsequent fees the purchaser is required to pay under the warranty contract, including diagnostic fees, service fees, or trip charges.

When a repair is performed on tangible personal property covered under a lump-sum warranty contract for real and tangible personal property, the seller of the warranty contract must pay tax on the repair services and may not issue a resale certificate.

If a warranty contract has separate charges for the coverage of tangible personal property and residential real property, then the charge for the coverage of tangible personal property is taxable. Subsequent fees the purchaser is required to pay under the warranty contract in relation to the tangible personal property are also taxable.

When a warranty contract covers both real and tangible personal property for separate charges, the taxability of each transaction between a third-party contractor or repairperson and the seller of the warranty contract depends on the type of property serviced- real property or tangible personal property- and whether the contract is lump-sum or separated.

Repairs After Disasters. The normal rules for taxing construction work change in declared disaster areas. For example, labor (not materials) to repair tangible personal property is exempt if the amount of the charge for labor is separately itemized and the repair is to

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134 *See* Comptroller Letter Memo No. 201701001L (January 25, 2017).

property damaged within an area declared a disaster area by the Governor of Texas or the President of the United States. We discuss these unique rules in Chapter VIII.

Insurance Services

Insurance services are subject to the sales tax if they meet several requirements. [135] First, the service must pertain to an insurance policy. Second, the service must be performed for an insurance company, its insureds, its policyholders or others. Third, the service must be listed as taxable. The Comptroller broadly construes the scope of insurance services. Presumably, any insurance service performed by anyone will be taxable if it somehow relates to an insurance policy.

> *Example*
>
> Law firm represents workers in construction-related lawsuits. Law firm hires Company A to perform several services, which include determining the extent of the worker's injuries and whether the construction company's negligence caused the worker's injuries. Company A does not determine whether the construction company is covered by insurance. Company A does not perform any services directly for any insurance company. The Comptroller's position is that Company A performs taxable insurance services if the construction company is covered by an insurance policy.

Insurance services are only subject to tax if they fall into one of the taxable categories. Taxable insurance services include:

- **Insurance loss or damage appraisal** – any activity performed for the purpose of either valuing damage to property or estimating the quantity, value or extent of loss of property.
- **Insurance inspection** – any activity performed to evaluate risks to property or to survey or value property in connection with furnishing insurance coverage.

- **Insurance investigation** – any activity performed to evaluate an insured's eligibility or qualifications for insurance coverage. This also includes evaluating whether an insured is eligible for benefits under an insurance contract. For example, the work a plumber

[135] Comptroller Rule 3.355.

performs to determine whether a leak caused foundation problems is taxable as an insurance service.

- **Insurance actuarial analysis or research** – any activity performed in connection with calculating rates for an insurance policy, annuity, etc.
- **Insurance claims adjustment and processing** – activities to supervise, handle, investigate, pay, settle or adjust insurance claims or losses. Services performed by public insurance adjusters are excluded from the definition of insurance services.[136] So, insurance services provided by a public insurance adjuster are not subject to sales and use tax.

  Example

  The Comptroller interprets "insurance claims adjustment" to include fees that physicians pay to have a third-party review rejected claims, make necessary corrections, and resubmit the claims to the insurance companies.

- **Insurance loss prevention** – activities performed in an effort to identify, analyze, evaluate, control, anticipate and/or eliminate the occurrence of accidents, losses or damage.

Health and Wellness Screening. Health and wellness screening services, such as electrocardiograms and collection and lab analysis of blood samples, remain nontaxable, even when performed on behalf of an insurance carrier, its insured, its policy holders, or when they otherwise pertain to insurance policies.[137]

FEMA Elevation Certificates. A Federal Emergency Management Agency (FEMA) Elevation Certificate is a document signed by an authorized land surveyor, engineer, or architect certifying building elevation information. According to the Comptroller, if a customer obtains an Elevation Certificate for insurance purposes, the charge to provide the certificate is taxable as an insurance service.

CPA Firms. Otherwise taxable insurance services are excluded from sales tax when they total less than 1% of the CPA firm's prior year's revenues.[138]

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136 Texas Tax Code § 151.0039(b)(2).

137 Comptroller Letter No. 200810293L.

138 Texas Tax Code § 151.0039(b) & (c) (eff. January 1, 2018).

Example

A CPA firm is paid $10,000 by an insurance company to determine the existence of fraud for purposes of loss coverage. The CPA firm generated revenues of $200,000 in the prior year. 1% of $2,000,000 is $20,000. Therefore, the CPA's fee of $10,000 is not subject to sales tax.

Insurance Tracking and Procurement Services. Fees paid by a lender to a business that tracks and confirms the existence of appropriate insurance on property serving as loan collateral is not subject to Texas sales tax as either data processing or insurance services.[139]

Example

Fast Loan, a lender, is in the business of underwriting collateralized loans for real property. The loan terms require the borrowers to maintain insurance on collateral property. All loans require hazard insurance, and some loans require flood insurance. Fast Loan needs to know immediately if a borrower does not maintain the required insurance coverage in order to protect itself from an uninsured loss.

Fast Loan hires Insurance Star to provide two services: tracking insurance coverage and obtaining insurance as needed. Insurance Star is an insurance agent and can place hazard and flood insurance on a property when the borrower's coverage lapses for any reason. Insurance Star monitors and processes insurance documents to determine whether borrowers have obtained and are continuing to maintain acceptable insurance.

Insurance Star's services are nontaxable services. The tracking and monitoring service is not data processing because the definition of data processing specifically excludes providers of other professional services who use a computer to facilitate performance of their services.[140] Further, even though Insurance Star's services are related to insurance, the services don't meet the definitions of taxable insurance services in the statute and Comptroller rules.[141]

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139 *See* Comptroller Letter No. 201701013L (January 31, 2017).

140 Texas Tax Code § 151.0101(a)(9); 34 Tex. Admin. Code § 3.330(a)(1).

141 Texas Tax Code § 151.0101(a)(12); Texas Tax Code § 151.0039; 34 Tex. Admin. Code § 3.355.

Data Processing Services

The Comptroller defines taxable data processing services as the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information.[142] This is a very broad and wide-ranging definition, which the Comptroller has used to tax a variety of services when they are performed using a computer. Texas tax law automatically exempts twenty percent (20%) of the charge for information services and data processing services.[143]

Examples of data processing include:

- check preparation,
- accounts payable or receivable preparation,
- web hosting,
- web site creation and maintenance,
- data storage, including offsite backup of electronic files, and
- conversion of data from one type of medium to another (*i.e.* converting paper documents or videotapes to digital files).

Data processing service providers include sellers of software as a service (SaaS) and application service providers.

Certain types of services that may arise in connection with construction services constitute taxable data processing, including computer-aided drafting when the client provides specifications; data conversion services; information storage; and producing reports from client's data.

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142 Comptroller Rule 3.330.

143 Texas Tax Code § 151.351.

Professional Services Exception. Data processing services do not include the use of a computer by a provider of other services when the computer is used to facilitate the performance of the service or the application of knowledge of accounting or law.[144] For example, the use of a computer and computer-aided design software by an architect during preparation of original building plans is not data processing. Similarly, a bookkeeper or accountant is not performing taxable data processing services when applying knowledge of accounting principles to produce financial reports such as income statements, balance sheets, profit or loss statements, or to prepare federal income tax, state franchise or sales tax returns, even if such work is performed on a computer.

Information Services

Information services means furnishing general or specialized news or other current information, including financial information, unless furnished to a newspaper or to a radio or television station licensed by the FCC; or electronic data retrieval or research.[145]

Taxable Information Service. This is information that is gathered, maintained, or compiled and made available by the provider of the information service to the public or to a specific segment of industry for a fee. In the construction industry, these taxable services include scouting reports and surveys, news clipping services, wire services, and title abstracts.

Providing access to information (databases maintained by the seller of the service) on the Internet is a taxable information service. The information is taxed at the server location rate even though it may be downloaded anywhere in the country or around the world. Texas tax law automatically exempts twenty percent (20%) of the charge for information services and data processing services.[146]

Database subscription services, including scientific data libraries, constitute taxable information services.[147] Examples include: scouting reports and surveys, title abstracts, providing access to information (databases maintained by the seller of the service) on the Internet. The Comptroller has taken the position that a service that provides information

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144 *Hegar v. Checkfree Servs. Corp.,* No. 14-15-00027-CV, 2016 WL 1576414 (Tex. App.—Houston [14th Dist.] April 19, 2016, no pet. h.) (mem. op.).

145 Texas Tax Code § 151.0038; Comptroller Rule 3.342.

146 Texas Tax Code § 151.351.

147 Comptroller Letter No. 200207275L (July 19, 2002).

regarding the availability of underground storage (such as salt dome reservoirs, abandoned salt mines and aquifers) is a taxable information service.[148] Similarly, taxable information services include the subscriptions by contractors to track market prices of materials or other pertinent data.

Non-Taxable Information Services. This includes information that is gathered or compiled on behalf of a particular client if the information is of a proprietary nature and may not be sold to anyone else (*i.e.*, opinion polls and management consultant reports); information derived from laboratory, medical or exploratory testing or experimentation or any similar method of direct scientific observation of physical phenomena (*i.e.*, geological surveys and medical test results); information required to be furnished pursuant to the Open Records Act; and information furnished to a member of a homeowners' association by or on behalf of the association.

Security Services

The Tax Code defines a taxable security service as any service for which a license is required under sections 1702.101 or 1702.102 of the Texas Occupations Code. These licenses are administered by the Private Security Bureau of the Texas Department of Public Safety. Taxable security services include a wide range of activities, such as: investigations, providing security guards or guard dogs, monitoring certain medical alert systems, installing or monitoring burglar alarm systems, providing armored cars or armed couriers, vehicle location and tracking (also known as Tele-Matics), unclaimed property services and computer forensic services (*e.g.*, locating and retrieving deleted or hidden computer files). Locksmith services and private security consulting services are also classified as taxable security services.

Medical alert services and the services of fulltime peace officers privately employed as guards or watchmen are not taxable security services. In addition, vehicle location and tracking service providers can be exempted from the licensing requirement by the Private Security Bureau if they pay an annual fee and meet certain operating standards.

Properly Collecting Tax Due. Taxable security service providers must collect state and all applicable local sales tax on the total amount billed for the services provided unless they receive a properly completed resale or exemption certificate from the purchaser. The

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148 *See* Comptroller Letter No. 9604L1407D01 (April 3, 1996).

taxable sales price includes incidental expenses billed to the customer, such as: meals, lodging, car rental and insurance.

Taxability of Items Used to Perform Security Services. Sales and use tax is due on most materials, supplies and equipment used to provide a taxable security service. For example, a company monitoring alarm systems must pay tax on purchases of computer equipment used to provide their service. A service provider can, however, give a resale certificate instead of paying tax on goods that are integral to performing the service and that are transferred to the care, custody, and control of the customer as a part of the service. For example, if a taxable service provider copies the results of her investigation to a CD to give to her customer, she can buy the blank CD tax free with a resale certificate. Taxable security service providers can also give a resale certificate instead of paying tax on a service that is an integral part of their taxable security service. For example, if a taxable security service provider purchases the services of a credit reporting service as part of a background check, he can give the credit reporting service a resale certificate instead of paying tax on the charges. A person providing nontaxable security services owes tax on all goods and services purchased to perform those services.

Reselling a Security Service. If a taxable security service provider purchases taxable security services from a third-party vendor and resells those services to its customer, the service provider can give a resale certificate to the third party instead of paying tax and then collect tax from its customer on the total charge.

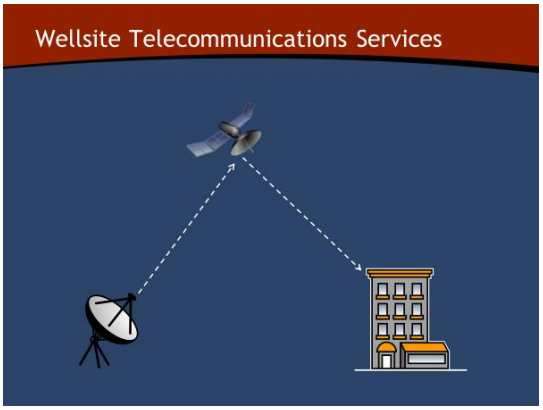
Contracts with Tax-Exempt Entities. A taxable security service provider should not charge tax when it provides security services for a government agency. In addition, schools, churches and public service organizations may provide their exemption letter along with an exemption certificate instead of paying tax.

To verify that an organization is exempt from sales tax, businesses can use the Comptroller's exempt entity search at:

https://comptroller.texas.gov/taxes/exempt/search.php

or call the Comptroller at (800) 252-5555.

Telecommunication Services



New industries have formed to provide high-tech services to remote locations, such as construction sites, oil fields, and farms. The taxability of these services varies depending upon their purpose and nature.

Remote Internet and Phone Services

Construction contractors may often require voice telephone (cell and landline) and Internet services at their work sites. They use these services to monitor various aspects of construction.

Telecom providers exist to perform these specialized services. Offsite, the telecom provider will usually own or lease and operate the facilities necessary to provide its services. The facilities are called the Telecommunications and Internet "backbone." The provider must also contract with the owner of satellites in geosynchronous orbit to send and receive signals. The telecom provider's facilities consist of one or more large satellite dish hubs and a "call manager" where the telecom provider's network engineers are located. From there, they operate and troubleshoot problems with the network.

The satellite hubs receive and send signals to and from the smaller dish satellites located at work sites. The hubs transmit data to the orbiting satellite, which, in turn, transmits the data to the "call manager." The "call manager" receives and sends signals to the smaller dishes located at the work sites so that the site workers may use their cell and landline phones, internet, etc.

As an Internet provider, the telecom provider serves as an Internet Service Provider ("ISP") for its customers. It supplies bandwidth, email services, email filtering, and web content. In addition, the telecom provider will usually own and operate its own email server and supply email addresses to customers.

To provide voice services, the telecom provider may purchase phone numbers and voice services from a telephone utility and resell them to as part of a communications package. It may serve as the ISP for these phone services. It will contract with the telephone utilities to enable it to provide access to the Internet through their switching equipment, which it then uses to provide Voice Over Internet Protocol services to its construction and oilfield service clients.

At the work sites, the telecom provider will typically sell, rent, provide and install the equipment necessary for the workers to have voice and Internet access to persons located offsite. These persons include its customers (general contractors and operators), subcontractors, remote engineers, and others who review, real-time, the telemetry data transmitted through the telecom provider's network described above.

In order to provide these services, the telecom provider must install the necessary telecommunications equipment at the work site. Each site will have a small satellite dish through which signals are transmitted. The telecom provider may mount routers, antennas, and other equipment on the control trailers. The telecom provider will install underground cable and wire in order to connect this peripheral equipment to the telecom provider's network. The peripheral equipment is configured before it is brought to the work site, so initial installation does not involve equipment configuration. Once the telecom provider installs the buried cable or wire and plugs in the peripheral equipment, the telecom provider's technician calls in a specific geocode to the call center to activate the equipment.

Taxability of Telecommunication Services

The Comptroller treats the charge for the telecom provider's services as a mobile telecommunications service.[149] Under this rule, local taxes are based upon the construction site. The telecom provider's work in installing the peripheral equipment, satellite dish and underground CAT-5 cables at the work sites constitutes new construction work.

Remote Monitoring and Alarms

Remote monitoring and alarm services are taxable as data processing services. The services include the processing and storage of remote readings from equipment. The readings may be accessed remotely by the taxpayer. Also, the taxpayer is sent text messages if alarm thresholds are triggered. Normally, monitoring and notification services are not taxable. But here, the taxpayer is storing data so that its customers can retrieve it.[150]

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149 Comptroller Rule 3.344(a)(6).

150 Comptroller Letter No. 201607899L (July 13, 2016).

Farm and Ranch Machinery and Equipment. Certain telecommunication services exclusively provided or used for navigating machinery and equipment used on a farm or ranch may qualify for a sales tax exemption.[151] To qualify, the equipment must be used to: (1) build or maintain roads, (2) build or maintain water facilities, or (3) produce agricultural products sold in the regular course of business. Purchasers must provide an agricultural exemption certificate in order to claim the exemption.

[151] *See* Texas Tax Code §§ 151.1551 and 151.316.

Chapter III. Sales & Use Tax Exemptions

Texas tax laws exempt various processes and equipment used in the construction industry in order to promote its economic growth in our state.

An entity claiming an exemption may issue an exemption certificate in lieu of paying sales tax on an item. Courts have held that both the seller and purchaser bear the burden of proving the exemption by "clear and convincing" evidence. The Comptroller and the courts construe all doubts in favor of non-exemption or taxability.

A buyer must provide an exemption certificate when the buyer or the item is exempt from the sales tax. A buyer must provide a resale certificate when the buyer plans to resell the item. In the latter case, sales tax collection ultimately occurs if the buyer resells the item to a consumer in Texas.

Accepting an Exemption Certificate

All of a seller's gross receipts are presumed to be subject to the sales tax unless the buyer furnishes the seller with a properly completed exemption or resale certificate. The sale of a taxable item by a person for delivery in Texas is presumed to be a sale for storage, use or consumption in Texas unless the seller accepts an exemption or resale certificate. The purchaser has the burden to claim the exemption to which he or she may be entitled.

If the seller does not receive an actual exemption certificate from the purchaser but instead receives only the purchaser's sales tax number, the seller should charge the purchaser sales tax on the transaction. The Texas Sales & Use Tax Act does not allow an exemption number or a tax-exempt number to be issued or used as a substitute for an exemption certificate.

Good Faith Acceptance

A sale is exempt if the seller receives in good faith from a purchaser a properly completed exemption certificate, and the seller lacks actual knowledge that the exemption is invalid.[152] A seller must look at the facts behind the exemption and reject an exemption certificate even if it appears to be valid if there is some reason to suspect that the exemption is being claimed in error.

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[152] The Comptroller's position is that resale and exemption certificates that aren't properly completed lose the good-faith presumption. Comptroller Hearing No. 41,214 (2002).

Example

A buyer purchases a TV set, has it delivered to his home and then claims a sales tax exemption from a local Red Cross shelter. The seller should further investigate the claim for exemption before accepting the certificate.[153]

After an audit, sellers have 90 days after notification by the Comptroller to gather and submit exemption certificates determined to be lacking. If the seller does not provide these certificates to the Comptroller within 90 days from the date the Comptroller gives written notice requiring possession of them, the Comptroller will disallow exemptions claimed by the seller that require delivery of the certificates. This rule applies to all types of exemption certificates, including direct pay exemption certificates. However, the seller and the Comptroller may extend this 90-day deadline by agreement.[154] The good faith presumption does not apply to the exemption certificates obtained during the audit and through the 90-day period. The auditor will probably scrutinize them carefully. Note that certificates are only required in order to claim exemptions. Exclusions and exceptions (such as government purchases) do not require the seller to obtain or the purchaser to produce an exemption certificate. However, sellers should keep invoices, receipts, etc. on file as verification of nontaxable sales.

Content of an Exemption Certificate

An exemption certificate must show all of the following or the Comptroller will disallow it: name and address of purchaser; description of the item to be purchased; reason the purchase is exempt from tax; signature of purchaser and the date; and the name and address of the seller.

Special Requirements for Exempt Gas and Electricity

Generally, charges for natural gas and electricity consumed at construction sites are taxable. There are exceptions for the construction of oil & gas wells, data centers, mines, and U.S. government contracts. In addition to the usual exemption certificate requirements, an entity claiming the gas and electricity exemption based upon qualifying use must include the following statement of exemption:

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153 *See* Comptroller Letter No. 200209465L (2002), which determined that a taxpayer could purchase a vehicle tax-free to be leased to the American Red Cross. If the vehicle ceased to be leased to the Red Cross (i.e., a divergent use), motor vehicle sales tax would be due on the owner's book value of the vehicle.

154 Texas Tax Code § 151.054(e).

> *A valid and complete study has been performed which shows that (insert the actual exempt percentage) of the natural gas or electricity is for processing tangible personal property for sale in the regular course of business.*[155]

It must also bear the original seal of the registered engineer who performed the study or a signed statement including the original signatures of the business owner and engineer.

☞ ***Caution:*** Be sure to use the proper form of the Exemption Certificate, which is available on the Comptroller's website at:

https://comptroller.texas.gov/taxes/sales/forms/ (click "Resale and Exemptions Certificates" to download both forms in a single PDF document)

Resale Exemption

A sale of a taxable item for resale is exempt from sales & use tax. A sale for resale is defined as a sale of a taxable item to any purchaser who is purchasing the item for the sole purpose of reselling, leasing or renting it within the geographical limits of the United States of America, its territories and possessions, or Mexico, in the normal course of business either in the form or condition in which it is purchased, or as an attachment to, or integral part of, other taxable items.[156]

Resale Certificates

A sale is exempt if the resale certificate is accepted in good faith and the seller lacks actual knowledge that the sale is not a sale for resale. It is the seller's responsibility to take notice of the type of business generally engaged in by the purchaser as shown on the resale certificate. The same documentation requirements that apply to exemption certificates also apply to resale certificates.

Requirements. A resale certificate must show the name and address of the purchaser; the number of the sales tax permit held by the purchaser or a statement showing that an application for a permit is pending, including the date the application was made. If the application is pending, the certificate is valid for 60 days, after which time the certificate must be renewed to show the permit number. (federal identification numbers or social security numbers are not acceptable evidence of resale). The certificate must state a description of the taxable items generally sold, leased or rented by the purchaser in the regular course of business and a description of the taxable items to be purchased tax free by

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155 Comptroller Rule 3.295(h)(2).

156 Texas Tax Code § 151.006.

use of the certificate; the signature of the purchaser and the date; and the name and address of the seller.

☞ ***Caution:*** Be sure to use the proper form of the Exemption Certificate, which is available on the Comptroller's website at:

https://comptroller.texas.gov/taxes/sales/forms/ (click "Resale and Exemptions Certificates" to download both forms in a single PDF document)

Materials Provided with Services

The definition of "sale for resale" includes sales of taxable services performed on tangible personal property held for sale by the purchaser of the taxable service and tangible personal property sold to a purchaser who acquires the property for the purpose of transferring it as an integral part of a taxable service.[157] Tangible personal property used to perform a taxable service is not considered resold unless care, custody and control of the property is transferred to the purchaser of the service.[158]

Example

Arturo's Flooring installs carpet under lump-sum contracts. The charge for the sale and installation of carpet is fully taxable because the carpet remains tangible personal property after it is installed. Arturo may issue a resale certificate when he purchases carpet and adhesive as long as Arturo transfers care, custody and control of the carpet and adhesive to the customer as part of the taxable service.

Taxable Use/Divergent Use

When an item purchased under a valid exemption certificate is used in a taxable manner, whether the use is in Texas or outside the state, the purchaser is liable for payment of sales tax based on the fair market rental value of the item for the period of time used. If the item has no fair market rental value, or if the exemption certificate is invalid at the time of issuance, the purchaser owes tax on the original purchase price.[159]

Example

White's Lumber sells construction materials, such as lumber, PVC, fixtures, etc. White's Lumber also performs nontaxable new construction services under lump-

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157 Texas Tax Code § 151.006.

158 *Sharp v. Clearview Cable TV, Inc.*, 960 S.W.2d 424 (Tex. App.—Austin, 1998).

159 There is a special rule for divergent uses of tangible personal property used in manufacturing, which is discussed later in these materials.

sum contracts. White's Lumber typically purchases its materials using a resale certificate and places them in inventory. One day, while constructing an office building, White's Lumber removes lumber from inventory for use in performing the nontaxable service. This is a divergent use. White's Lumber must accrue and remit use tax on the price it paid for the lumber when it takes it out of inventory and uses it in performing the nontaxable service.

Out-of-State Retailers

A Texas seller may accept a resale certificate in lieu of tax from a bona fide retailer located in a state outside of Texas who purchases taxable items for resale. The resale certificate must show the signature and address of the purchaser, the state to which the property is taken for resale and the sales tax permit number, if any, or the registration number assigned to the purchaser by the purchaser's home state. The resale certificate must also state the type business engaged in by the purchaser and the type items sold in the regular course of business. An invoice describing the taxable item purchased and showing the exact street address or office address from which the taxable item will be sold must be attached to the resale certificate.

Mexican Merchants

A purchaser may give a properly completed resale certificate to a Texas seller if acquiring a taxable item for the purpose of selling, leasing, or renting the item in Mexico in the normal course of business. The resale certificate must show the purchaser's Mexican federal identification number (Federal Taxpayers Registry) and provide a copy of the Mexican Registration Form to the seller.

Other Foreign Merchants

Complex rules govern the documentation required for maintaining exemptions for imports and exports. The discussion of these complex rules is beyond the scope of this course.

Chapter IV. Construction Industry Principles

Personal v. Real Property

In order to apply the rules for the taxable services that are routinely performed in the construction industry, we must first learn which types of property are classified as real property and which types are personal property. While the charge for the repair of either is a taxable service, the distinction is critical in a number of other contexts: maintenance, whether the service is taxable as a real property service, the classification of contracts between lump-sum and separated, and the exemptions that may apply, such as manufacturing.

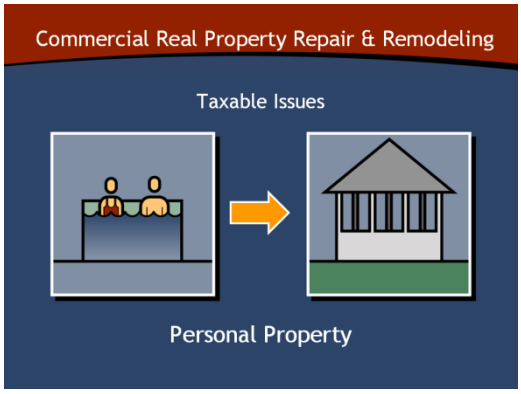
Texas law defines real property as land, including structures and other improvements embedded in or permanently affixed to the land. Texas law states three factors that bear on the appropriate classification of real versus tangible personal property:

1. the mode and sufficiency of annexation to realty,
2. the intent of the party who annexed the personal property to real property, and
3. the intent of the parties.[160]

Comptroller auditors are directed to determine the parties' intent by reviewing the contracts, AFEs, annual reports and other documentation as evidence of it.[161]

Example

A hot tub is purchased and installed in a portable gazebo in a backyard. The portable nature of the gazebo may indicate an intent that the hot tub will be moved when the owner sells the house. This indicates that the hot tub is *personal* property.

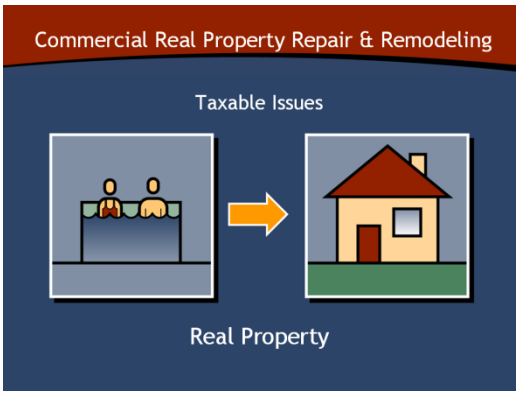


[160] *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); *Hutchins v. Masterson & Street*, 46 Tex. 551 (1877).

[161] Audit Procedures for Contractors & Repairmen, p.1. (April 2017), *available at* https://comptroller.texas.gov/taxes/audit/docs/contractor-manual.pdf.

Example

A hot tub is installed in a new addition to the house and is added to the new room as it is being built. To remove the hot tub would require tearing out one of the new walls. In this case, the hot tub is real property.



Modular Buildings. The Comptroller treats modular buildings as tangible personal property when the parties to the lease of the modular buildings agree that the buildings are temporary and are to remain tangible personal property, regardless of how they are installed or attached to the lessee's real property.[162]

Residential v. Commercial Property

The charge for the service of any type of residential construction (including remodel) is not taxable. "Residential structures" include houses, apartments, condominiums, nursing homes and retirement homes.[163] However, hotels, motels, hospitals, prisons, rehabilitation centers, and recreational vehicle parks are not residential structures.

Real Property Services for Homebuilders.

Real property services are taxable services, but they are not taxable if purchased by a homebuilder as part of a contract to build a new residential structure or other improvement next to the new residential structure and used in the residential occupancy of the structure.

Examples of new improvements next to a new residential structure include: new rooms, sidewalks, swimming pools, gazebos, garages, fences, sprinkler systems, decks, retaining walls, driveways, fishponds and patios. The tax exclusion for real property services provided while constructing these new improvements applies only in connection with building a new residential structure (living quarters).

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162 Comptroller Hearing No. 102,946 (2010).

163 *See* Comptroller Rule 3.357.

If a homebuilder is constructing a new residential structure under a lump-sum contract, the homebuilder is considered the ultimate consumer but does not owe tax on purchases of real property services. Under a separated contract to build a new residential structure, the homebuilder does not owe tax on purchases of real property services but must include these costs in the labor portion of the contract.

Model Homes.

A homebuilder may not issue an exemption certificate for services performed on a model home while the builder uses and occupies the model home as a display or as a sales office. However, during construction of the model home or conversion of the model home to residential use, the services are not taxable, and the builder may properly issue the certification.[164]

Modular Furniture. Charges for the initial assembly of modular furniture are taxable as fabrication labor, and charges for the disassembly and reconfiguration of previously assembled furniture are taxable as repair and remodeling labor.[165]

Charges to transport furniture or relocate furniture within a building are not taxable, and charges to disassemble, reconfigure, and reassemble are not taxable if the services are performed in conjunction with moving the furniture.

New Construction

The Comptroller, by rule, defines new construction as "all new improvements to real property including initial finish out work to the interior or exterior of the improvement."[166] New construction also includes the addition of new, usable square footage to an existing structure.[167] For example, adding a second floor to a one-story building without raising the roof of the first floor is new construction.

The issue of new construction is only relevant in the case of work performed on commercial (non-residential) structures because labor charges for residential work are not taxable, regardless of whether the work is performed on new or existing structures.

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164 Comptroller Letter Nos. 9606305L (1996) (partially superseded on other grounds) and 9510782L (1995).

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166 *See* 34 Tex. Admin. Code § 3.357(a)(8).

167 *See* 34 Tex. Admin. Code §§ 3.291 and 3.357(a)(8).

Many activities qualify as non-taxable construction:[168]

- construction of an improvement to residential or nonresidential realty;
- first or initial finish-out work to the interior or exterior of an improvement to realty;
- addition of new, usable square footage to an existing building;
- hardscaping;
- total demolition of an improvement to realty and creating a new improvement to realty;
- increased capacity in a production unit in a petrochemical refinery or chemical plant;
- improvements to real property as part of periodic and scheduled maintenance of nonresidential real property; or
- repairing, remodeling and restoring *residential* property.

☞ ***Caution:*** Removing or relocating interior walls to expand the size of a room, or the finish-out of an office space that was previously used for storage would be considered remodeling rather than new construction. Raising the ceiling of a room or the roof of a building is not new construction unless new, usable square footage is created.[169]

Sometimes, a project may contain elements of both new construction and taxable repair and remodeling. When a contract contains a single charge for both taxable services and non-taxable or exempt services or items, the total charge is taxable unless an exception applies.

For example, if a nontaxable service and a taxable service are purchased for a single charge and the portion of the fee relating to the taxable services represents more than 5% of the total charge, the entire fee is presumed taxable.[170] To prevent the entire charge from being treated as taxable, contractors should separately state bills for new construction from repairs and remodeling.

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168 Comptroller Rule 3.291 provides specific guidance for what type of work constitutes new construction.

169 Comptroller Rule 3.291(a)(9).

170 *See* 34 Tex. Admin. Code § 3.357(b)(9).

Example

An office building adds a new wing adjacent to and connected to its old building. The project involves laying a foundation for the new wing and constructing the wing itself. A wall in the old building is knocked out and replaced with an archway to provide access to the new wing. While the new wing is clearly non-taxable new construction, the work associated with demolishing the old wall and replacing it with an archway are considered taxable repair and remodeling. The total charge would be apportioned accordingly.

Example

A pipeline services company is replacing a section of a large utility pipeline. In the first part of the job, the company shuts down the pipeline, excavates the old portion, and replaces the section of pipe before putting the line back in service. In the second part of the job, the company leaves the pipeline in service and constructs the new section in a separate ditch alongside the old line. When completed, the pipeline is shut down, the old line cut out, and the new line welded in. The pipeline is then restarted and the old section of pipe removed from the old ditch. Since pipelines are usually considered real property, the first part of the job involves taxable repair and remodeling of commercial real property. However, the Comptroller has held that the second part of the job constitutes non-taxable new construction except for the excavation of the old line and the connection of the new line into the pipeline. The total charge should be apportioned accordingly.

☞ ***Caution:*** A Comptroller hearing decision determined that replacing an oil & gas storage tank's floating roof with a new cone roof was not new construction, even though it added cubic footage to the tank.[171]

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171 Comptroller Hearing No. 38,069 (1999).

Construction of an Improvement to Realty.

Construction of an improvement to residential or nonresidential realty where one did not exist is new construction. This includes everything from erecting a building to dredging a channel in an unimproved body of water. Once the improvement to realty is completed, changes to the structures are governed by Comptroller Rule 3.357, unless the work qualifies as new construction under one of the criteria in the "New Construction" section.

First Finish-out or Initial Finish-out.

Completing the interior or exterior of an unfinished improvement to realty so that it complies with the owner's or lessor's requirements is initial finish-out. For example, if a multiple story building had only its first floor finished and occupied, the initial finish-out of each additional floor prior to occupancy would be deemed new construction.

The Comptroller does not treat finish-out work performed after initial finish-out as new construction. Instead, the Comptroller treats the work as remodeling, even though the improvement has not been occupied. For instance, if the initial finish-out of the first floor of a multiple story building has been completed but no one has occupied that floor, any additional finish work will constitute remodeling. The improvement will also be considered finished out if it has been previously put to an alternate use. For example, an unfinished room in an office building that has been used for record storage instead of office space will be considered finished. In this case, subsequent finish out is remodeling.

Addition of New Usable Square Footage.

New construction includes the addition of new footage to an existing structure. Modifying parts of existing structures for the sole purpose of supporting the addition of new space will not change a new construction contract into a remodeling contract as long as the charges attributable to remodeling are 5 percent or less of the overall charge. Contracts with remodeling charges exceeding 5 percent are presumed fully taxable unless the charges for remodeling are separately identified to the customer. In cases where the charge for the remodeling service is not separately-stated, either the service provider or the purchaser may establish, through documentary evidence, the taxable percentage of the total contract price.

Examples of new construction based on additional footage includes:

- Expanding the square footage of an existing one-story building,
- Adding floors to an existing building,
- Adding a pitched roof to a flat roof creating attic storage space,

- Installing a new story (floor) to a building without raising the roof,
- Adding additional length or width to an existing street or parking lot,
- Demolishing the foundation of a one-story building and adding a basement below ground level, and
- Adding an exterior elevator to an existing building.

Examples of additional footage jobs that do not qualify as new construction include:

- Modifying an existing nonresidential improvement to realty in conjunction with new construction when the remodeling exceeds 5 percent of the contract charge and the contract or other controlling document does not separate charges for new construction and remodeling,
- Adding fascia or false walls around an existing nonresidential improvement to realty for appearance when no usable space is created,
- Raising the ceiling of a room or the roof of a building that does not create new usable square footage,
- Adding another layer of asphalt to a street or parking lot, or
- Paving a street or parking lot after removing asphalt but not base materials.

Hardscaping

Hardscaping qualifies as a permanent improvement to real property. An entity performing either the first installation of hardscaping or the repair, remodeling or restoration of residential hardscaping is a contractor.

Hardscaping is often performed in conjunction with landscaping. Examples include:

- sprinkler systems,
- retaining walls,
- rock work,
- ponds,
- pools,
- fences,
- drainage ditches,

- dams, and
- lighting permanently attached to real property.

Hardscaping does not include activities classified as landscaping, such as:

- garden planting or maintenance,
- arborist services,
- ornamental bush or shrub planting,
- tree planting or removal,
- tree surgery,
- pruning or spraying, and
- lawn sodding.

Complete Demolition of an Improvement to Realty and Rebuilding.

The charge for the complete demolition of an improvement to real property is not taxable.[172] For example, if an improvement to realty, such as a building, parking lot or sidewalk, is totally demolished and another improvement to realty is built on the same site, the charges for both the demolition and rebuilding are treated as new construction labor. In this case, "demolished" means razed to the slab for a building and reduced to virgin earth for the parking lot or sidewalk.

Partial demolition of a nonresidential improvement to real property is taxed as remodeling.[173]

Tax Effects of New Construction of Commercial Real Estate. The labor charge for constructing a new commercial structure is not taxable. The sales tax effects are the same as for residential property. The taxability of the tangible personal property involved in the new construction of commercial property will depend on the type of contract: lump-sum or separated.

Contract Pricing

Contract pricing terms are crucial to determine the tax responsibilities of contractors. Comptroller Rule 3.291 states that contractors, defined below, perform non-taxable

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172 Comptroller Rule 3.357(a)(11).

173 Comptroller Rule 3.357(a)(11).

services. Thus, it's important to know when a taxpayer is classified as a contractor. The rule defines a contractor is any person who:[174]

- builds new improvements to residential or nonresidential real property;
- completes any part of an uncompleted new structure that is an improvement to residential or nonresidential real property;
- makes improvements to real property as part of periodic and scheduled maintenance of nonresidential real property; or
- repairs, restores, maintains, or remodels residential real property, and who, in making the improvement, incorporates tangible personal property into the real property that is improved.

The Comptroller's Rule 3.291 defines the term "contractor" to include subcontractors but does not include material men, suppliers, or persons who provide taxable real property services.[175]

Who Owes the Tax. While the charge for the labor component of the above activities is not taxable, the type of contract determines which party owes sales tax on the charges for or cost of the materials. In the absence of a written contract, a written bid will control. If neither a written contract nor a written bid exists, the written invoice determines tax responsibilities. The invoice itself is not a contract because it is not generated until work is performed; therefore, it cannot be viewed as either an offer or an acceptance but simply a billing for the work.

- **Lump-Sum Contract.**[176] Under a lump-sum contract, a contractor is considered the consumer of all materials incorporated into a customer's property. As a consumer, a contractor must pay tax to suppliers at the time of purchase. The contractor will also pay sales and use tax on consumable supplies and all equipment bought, leased or rented for use on the job. The lump-sum charge to the customer is not taxable.
- **Separated Contract.** Under a separated contract, a contractor is considered the retailer of all materials physically incorporated into the realty. As a retailer, a separated contractor must collect sales tax from the customer based on the agreed-upon contract

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174 *See* Comptroller Rule 3.291.

175 *Id.*

176 A contract to improve realty that does not break out the charge for labor and materials.

price of the incorporated materials. The separately-stated charge for labor is not taxable. The contractor may issue a resale certificate to purchase the materials. The contractor owes sales tax on consumable supplies and all equipment bought, leased, or rented for use on the job.

Real Property Services. A contractor may purchase real property services incorporated into new residential construction tax-free. The contractor must issue the real property service provider an exemption certificate or letter claiming the exemption.

Determining the Contract Type

Lump-sum Contract. A lump-sum contract is a contract in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separate from any charges for skill and labor, including fabrication, installation, and other labor that the contractor performs. For example, guaranteed-maximum contracts are considered lump-sum contracts when the charges for incorporated materials and the charges for skill and all labor are not separately stated.

Contracts that do not break out all charges for labor, including fabrication labor, are considered lump-sum contracts. For example, a contractor who fabricates and incorporates cabinets into realty under a contract that includes the fabrication labor in the agreed contract price of materials is performing his work under a lump-sum contract.

Contracts to improve realty that have a zero charge price for materials or for labor are considered lump-sum contracts. Under a lump-sum contract, the contractor is considered the ultimate consumer. The contractor owes tax on the purchases of incorporated materials, equipment, consumable items and taxable services.

- **Separated Invoices.** Separated invoices issued to the customer will not change a lump-sum contract into a separated contract unless the terms of the contract require separate invoices.

Lump-sum Contract Examples:

Example 1	
Labor and materials	$ 1,750,000
Total	$ 1,750,000

Example 2	
Foundation	$ 15,000
Metal work	30,000
Plumbing	10,000
Electrical	20,000
General	300,000
Total	$ 375,000

Separated Contract. In a separated contract the agreed contract price is divided into a separately-stated price for incorporated materials and a separately-stated price for skill and labor. Labor means all skill and labor that includes fabrication, installation, and other labor that is performed by the contractor. If prices of incorporated materials and labor are separately stated in any part of the contract or in a document that becomes part of the contract according to the terms of the contract, adding the charges together to give a sum total does not change the contract into a lump-sum contract. If prices of incorporated materials and labor are separately-stated, the fact that the charges are added together and a sum total given are irrelevant.

- **Documents Incorporated by Reference into the Contract.** Documents incorporated by reference become part of that contract.[177] When a document is incorporated into another by reference, both instruments must be read and construed together.[178] Under Comptroller policy, the terms of the contract or of an incorporated document must separately state the charges for incorporated materials and labor in order for the contract to be considered a separated contract.[179]

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177 *In re 24R, Inc.*, 324 S.W.3d 564, 567 (Tex. 2010).

178 *In re C&H News Co.*, 133 S.W.3d 642, 645-46 (Tex. App.— Corpus Christi 2003, no pet.); *Bob Montgomery Chevrolet, Inc. v. Dent Zone Cos.*, 409 S.W.3d 181, 189 (Tex. App.—Dallas 2013, no pet.).

179 *See* Comptroller Hearing No. 49,560 (2009).

If incorporated by reference, the terms of a Prime Contract can affect whether a subcontract is classified as lump-sum or separated.

- **Material & Labor Charges Commingled.** A contract between a contractor and his customer that contains a lump-sum price covering both the performance of labor and the furnishing of the necessary incidental materials is a lump-sum contract.[180] If any component of the total sales price commingles any portion of the associated labor charge with any portion of the associated non-labor charge that make up the total sales price, then the contract is a lump-sum contract.[181] Stated another way, the charge(s) for materials must be stated separately from all other charges.

  Comptroller policy confirms this rule, stating that "[t]he key in determining whether a contract is lump-sum or separated is whether all material costs are separately stated. It is not sufficient that some of the material costs are set out and other are included in lump-sum portions of the contract."[182]

  Under a separated contract, the contractor is considered a retailer of the incorporated materials and must collect sales tax from the customer. Tax is due on the price of the materials, as agreed in the contract, or the cost of the materials to the contractor, whichever is greater.

  The contractor may maintain a tax-free inventory of items held for resale. Items purchased exclusively for resale may be purchased tax-free by issuing a resale certificate to suppliers in lieu of paying taxes. A contractor must hold a sales tax permit to issue a resale certificate.

  The contractor owes tax on the purchases of equipment, accessories, most consumable items, and taxable services. A developer or general contractor may purchase real property services incorporated into residential new construction tax-free.

  A contractor who performs work under separated contracts for a customer holding a direct payment permit may accept the direct payment certificate in lieu of charging taxes on the price of the incorporated materials.

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180 *See* Texas Tax Code § 151.056(a).

181 *See id.*; *See* Comptroller Hearing No. 15,636 (September 13, 1964) ("[T]he Tax Division has adopted a uniform policy of considering all contracts as lump-sum contracts under Texas Tax Code Ann. Sec. 151.056 (Vernon 1982) unless there is a complete separation of all labor and material charges."); *See* Comptroller Letter No. 200103090L (Mar. 6, 2001) (same).

182 Comptroller Hearing No. 24,582 (1992) (superseded on the issue of error rate for missing records).

Separated Contract Examples

Example 1

Materials	$ 15,000.00	customer owes tax on this amount
Labor	17,500.00	
Tax	1,237.50	[$15,000 x tax rate]
	$33,737.50	

Example 2

Materials	$10,000.00	
Labor	20,000.00	
Equipment	2,000.00	
Consumables	620.00	
Permit fees	250.00	
Tax	825.00	[$10,000 x tax rate]
	$33,695.00	

- **Cost-Plus Contracts.** The Comptroller general classifies a cost-plus-a-fee contract as a separated contract. The taxability of the profit and overhead depends on the invoicing procedures. If the invoice states material charges or costs without tying a profit or additional percentage charge to them, then tax is due only on the stated material charges or costs. But if the invoice in any way indicates a profit or mark-up related to materials then tax is due on the combined total of the material charges and profit or mark-up.

Cost-plus Contract Examples

Example 1

Materials	$15,000.00	customer owes tax on this amount
Labor	17,500.00	
Mark-up	3,200.00	
Tax	1,237.50	[$15,000 X tax rate (8.25%)]
	$36,937.50	

Example 2

Materials	$10,000.00	customer owes tax on this amount
Labor	20,000.00	
Mark-up on materials	1,000.00	customer owes tax on this amount
Mark-up on labor	2,000.00	
Equipment	2,000.00	
Consumables	620.00	
Permit fees	250.00	
Tax	907.50	[$11,000 X tax rate (8.25%)]
	$36,777.50	

Company asks Builder to bid on a project to build an office complex. Builder issues a separated bid for the job. Company and Builder sign a lump-sum contract. Builder issues monthly invoices with separately-stated material and labor amounts. The lump-sum contract will determine tax responsibility. Builder owes tax on all taxable purchases and cannot issue a resale certificate. Builder will not collect tax from Company.

- **Guaranteed Maximum.** The Comptroller classifies contracts with separate charges for materials, labor and profit with a guaranteed maximum amount to be paid by the customer as separated contracts. Stating a single maximum amount does not transform the contract from separated into a lump-sum contract. As with any separated contract, the tax rate is applied to the price of the materials as agreed in the contract or the price of the materials to the contractor, whichever is greater.
- **"Schedule of Values."** A "schedule of values" incorporated by reference into a lump-sum contract can transform it into a separated contract. Comptroller hearing decisions provide insight into the arguments and proof necessary to accomplish these pricing reclassifications. In Comptroller Hearing No. 49,560, the taxpayer provided heating, ventilating and air conditioning (HVAC) contracting services for new construction.[183] The taxpayer entered into a subcontract with a contractor who, in turn, had entered into a contract with a prime contractor performing commercial new construction for the owner of a hotel. The taxpayer did not pay sales tax to suppliers for materials it incorporated into the job. The taxpayer claimed that its contract qualified as a separated contract for sales and use tax purposes, and therefore, it qualified for the sale for resale exemption. The contract, however, stated a lump-sum price.

  The taxpayer based its claim on three arguments. First, the taxpayer argued that the contract was a separated contract by its terms because the incorporated materials and labor were separately-stated in a schedule of values, which was specifically incorporated by the contract.[184]

  In this hearing, however, even though the contract required a statement of values on which to base applications for payment, the contract did not require the statement of values to break out the charges for incorporated materials and labor. Additionally, the taxpayer could not provide a copy of the statement of values as evidence. The

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183 Comptroller Hearing No. 49,560 (2009) (STAR No. 200905415H).

184 Comptroller Hearing No. 40,445 (2002) (STAR No. 200205246H).

Comptroller determined that the testimony regarding the statement of values was insufficient evidence of a separated contract.

Second, the taxpayer argued that the contract was separated because the parties intended it to be separated and treated it as such. The taxpayer initially billed the contractor for sales tax on the incorporated materials. The contractor directed the taxpayer to cease charging tax on the incorporated materials and provided the taxpayer with a resale certificate for them.

Subsequently, the contractor submitted two change orders, one directing the taxpayer to deduct an amount of sales tax from the original contract amount, another directing the taxpayer to apply a credit in sales tax against the contract amount. Per taxpayer testimony, the taxpayer had charged sales tax on materials only, and the change orders were triggered by the issuance of the resale certificate. Regarding whether these documents served to establish intent, the Comptroller held that intent could not be given any weight under established Comptroller precedent.[185] The Comptroller stated, "The parties' intent cannot override the clear language of the contract providing for a lump-sum contract price."

Third, the taxpayer argued that the contract was separated because it incorporated the contract between the prime contractor and the owner, which, it claimed, was separated. The Comptroller did not address the argument because the taxpayer could not produce a copy of that contract nor describe its provisions.

The taxpayer lost the administrative hearing: the Comptroller did not reclassify the contract from lump-sum to separated. However, the taxpayer's loss resulted from an absence of proof and not from erroneous legal positions. The taxpayer would have likely won had it been able to present the necessary proof.

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[185] *See* Comptroller Hearing No. 35,473 (1996) (STAR No. 9611019H); *See* Comptroller Hearing No. 24,368 (1990) (STAR No. 9001H0982E11).

Controlling Documents

There is a hierarchy established to determine tax responsibilities:

1. contract, then
2. bid, then
3. invoice.

The controlling document takes precedence over other documents that may be provided unless these documents are required by the controlling document. For example, separate invoices issued to a customer will not transform a lump-sum contract into a separated contract unless the terms of the contract require separate invoices.

For sales tax classification purposes, the terms of a contract control over the terms of a bid. For example, when the bid is lump-sum but the written contract is separated, the contract controls the tax responsibilities of both the contractor and the customer. The terms of a contract also control change orders.

If there is no written contract, a written bid becomes the controlling document. A bid is an offer to perform work for a specified amount of consideration. Awarding the work to a specific bidder constitutes an acceptance and the bid becomes the contract.

Situation 1

Company asks Builder to bid on a project to build an office complex. Builder issues a separated bid for the job. Company and Builder sign a lump-sum contract. Builder issues monthly invoices with separately-stated material and labor amounts. The lump-sum contract will determine tax responsibility. Builder owes tax on all taxable purchases and cannot issue a resale certificate. Builder will not collect tax from Company.

Situation 2

Company asks Builder to bid on a project to build an office complex. Builder issues a separated bid for the job. Company accepts the bid and awards the job to Builder. Builder issues monthly lump-sum invoices to Company.

Since there is no contract, the accepted bid determines tax responsibilities. Builder owes tax on the purchases of equipment, most consumable items and taxable services but may issue a resale certificate for materials incorporated into the realty. Company owes tax on the agreed contract price of materials

incorporated into the realty and must obtain a receipt from the builder reflecting the payment of tax by the customer on the material charge.

Situation 3

Company asks Builder to bid on a project to build an office complex. Builder issues a separated bid for the job. Company and Builder sign a lump-sum contract stating that the invoices become a part of the contract. Builder issues monthly invoices with separately-stated material and labor amounts.

When a lump-sum contract includes documents that separate the prices of the materials incorporated and the skill or labor, the lump-sum contract becomes a separated contract. Builder owes tax on the purchases of equipment, most consumable items and taxable services, but may issue a resale certificate for materials incorporated into the realty.

Company owes tax on the agreed contract price of materials incorporated into the realty and must obtain a receipt from the builder reflecting the payment of tax by the customer on the material charge.

Course of Dealing

Contracts between property owners, general contractors, and subcontractors are governed by general contract principles.[186] When construing a contract, the primary goal is to determine the parties' intent as expressed in the terms of the contract.[187] Comptroller policy shows that the Comptroller will consider evidence of the parties' proven course of dealing to determine whether a contract is lump-sum or separated.[188]

As a general rule, Comptroller policy holds that "it is immaterial why a contract includes separate charges for materials and labor; the inquiry is only whether it does so. If the materials costs can be accurately determined, this is sufficient to make the contract a

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186 *Raymond v. Rahme*, 78 S.W.3d 552 (Tex. App.—Austin 2002, no pet.).

187 *See Chrysler Ins. Co. v. Greenspoint Dodge of Houston, Inc.*, 297 S.W.3d 248, 252 (Tex. 2009); *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983).

188 *See* Comptroller Hearing No. 19,385 (1987); Comptroller Hearing No. 34,808 (1996).

separated contract."[189] "The parties' intent cannot override the clear language of the contract providing for a lump-sum contract price."[190]

However, the Comptroller cautions against a narrow interpretation of this policy that cuts against general contract law principles.[191] In Comptroller Hearing No. 19,385, the Comptroller applied contract law principles of offer and acceptance in its analysis. The Comptroller reasoned that ideally there would be a formal written contract between the parties to analyze, however, "that is not always the case. Many times, as here, there is no formal contract, or no single document containing the agreement or understanding of the facts."[192] In this hearing, the Comptroller considered evidence of the parties' proven course of dealing to show that the parties normally entered into formalized lump-sum contracts. The parties' proven course of dealing, combined with the fact that the customer paid taxes on its purchases of materials, was sufficient to prove that the contract was lump-sum. The Comptroller stated, "[O]ur inquiry in any such case is to determine the true nature of the contract."[193]

In Comptroller Hearing No. 34,808, the taxpayer was a business that sold and installed flooring. The taxpayer's jobs included new improvements to real property and repairs and remodeling of real property. The taxpayer did not have written contracts, and only had control forms and written proposals for a small portion of its jobs. The taxpayer argued that his written proposals that showed tax on materials to be used as a separate item were sufficient to make his contracts separated contracts, despite the fact that the taxpayer's invoices only showed lump-sum billing. The Comptroller relied on the precedent of Hearing No. 19,385 and considered the parties' course of dealing in his analysis. In this case, no course of dealing was established between the taxpayer and his customer because the taxpayer did not consistently give proposals to its customers.

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189 Comptroller Hearing No. 40,445 (2002), citing Comptroller Hearing No. 24,582 (1992) (superseded on the issue of error rate for missing records).

190 Comptroller Hearing No. 49,560 (2009).

191 *See* Comptroller Hearing No. 19,385 (1987) ("Apparently, the tax division wants to say that in the absence of a formal contract, or when the taxpayer is unable to present a formal contract, we look only to the format of the ultimate billing(s) to determine whether the agreement was separated or lump-sum. That might be reasonable, and it might be defensible if a rule had been adopted to that effect; but obviously the law of contract is not so narrow.").

192 *See* Comptroller Hearing No. 19,385 (1987).

193 *Id.*

Reimbursements

Contractors and taxable service providers often incur business expenses that are reimbursed on a dollar-for-dollar basis from customers. The tax treatment of reimbursements from a contractor's customer depends on the contractual terms, the type of work, and the reimbursement type.[194]

Reimbursements Under Lump-Sum Contractors. Under a lump-sum contract, the Comptroller's rules treat the contractor as the consumer of all items purchased to perform the work. Reimbursement charges that are incorporated into a lump-sum contract are not taxable, and the contractor should not collect sales tax from the customer on materials, labor, or reimbursements that are part of the lump-sum charge.

Comptroller's Example

Robert (under a lump-sum contract) completes a kitchen-remodeling project for an existing home in Austin, Texas. He invoices his customer:

- Kitchen Remodeling: $45,000
- Includes:
  - Materials
  - Labor
  - Meal Reimbursements
  - Fuel Reimbursements
- Total Price: $45,000

Robert does not need to collect any sales tax from his customer.

Reimbursements Under Separated Contracts. Under a separated contract, the Comptroller's rules treat the contractor as the seller of the materials that the contractor incorporates into the real property improvement. The contractor may provide a resale certificate to its supply vendor instead of paying tax on the charges for the incorporated materials. The contractor must collect tax on its charges to its customer for the incorporated materials. The customer does not owe and the contractor should not charge, tax on the charge for labor. Any reimbursements sought that relate to the materials charges, such as fuel reimbursements to pick up and deliver materials, are taxable as a

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[194] Texas Comptroller Tax Policy News (Nov. 2019), *available at* https://comptroller.texas.gov/taxes/tax-policy-news/.

component of the sales price to the customer for the materials. Reimbursement charges related to the nontaxable labor, including wait time, per diem and lodging, are not taxable.

Comptroller's Example

Robert (under a separated contract) invoices his customer for the following:

- Kitchen Remodeling:
  - Materials: $25,000 (taxable)
  - Labor: $19,000 (nontaxable)
  - Meal Reimbursements: $500 (nontaxable)
  - Fuel Reimbursement for Material Pickup: $300 (taxable)
  - Wait time: $200 (nontaxable)
- Subtotal: $45,000
- Sales Tax (8.25%): $2,087.25
- Total Price: $47,087.25

Robert must collect sales tax on the taxable portions of the separated contract: materials ($25,000) and fuel reimbursement ($3,00).

Sales Tax Due = 8.25% ($25,300) = $2,087.25

Reimbursements for Equipment and Consumables. Contractors working under both lump-sum and separated contracts for improving real property must pay tax on charges to them for equipment the contractors purchase or rent for a job. A contractor also owes tax on charges for consumables used at the job site (unless its customer is tax-exempt). Contractors should not charge tax to customers on their charges for reimbursements of equipment and consumables.

A contractor working under a separated contract may seek reimbursement from its customer for the contractors' payments for renting equipment and purchasing consumables that the contractor uses on the job. The contractor must clearly label these items as reimbursement and not charge its customer sales tax on the reimbursement charges. Instead, the contractor must pay tax when it rents the equipment or buys the consumables.

Comptroller's Example

Robert rents an excavator and purchases consumables to install a new irrigation system for a non-exempt customer under a separated contract. He invoices his customer for the following:

- Irrigation Installation:
  - Materials: $20,000 (taxable)
  - Labor: $15,000 (nontaxable)
  - Consumables Reimbursement: $1,000 (nontaxable to customer)
  - Equipment Reimbursement: $5,000 (nontaxable to customer)
- Subtotal: $41,000
- Sales Tax (8.25%): $1,650
- Total Price: $42,650

Robert has separately-stated on his invoice to his customer the reimbursements for the amounts he paid to purchase consumables and rental equipment. He should have paid sales tax to his vendors when he bought the consumables and rented the equipment and does not need to collect tax from his customer on these charges. He must, however, collect tax on the materials charges.

If the contractor's invoice does not show that charges are for reimbursements for equipment rental or consumables and that the contractor paid tax to its vendors on the charges for them, the contractor must pay over to the Comptroller any charge represented as sales or use tax on the customer invoice. The Comptroller advises contractors to document that these are expense reimbursements to avoid the customer's perception that the contractor is charging and collecting tax from the customer on its invoice.

Reimbursements for Taxable Service Providers. If the contractor performs nonresidential real property repair, remodeling, or restoration, the entire charge to its customer, including charges for services are taxable. The contractor owes tax when purchasing or renting equipment and consumables. These items are not resold to the customer.

A taxable service provider must collect tax on all charges billed to the customer for the taxable service regardless of whether the contract is lump-sum or separated. The taxable

service provider must charge tax on a lump-sum charge, including any reimbursements that are included in the lump-sum charge.

Comptroller's Example

Robert renovates an employee breakroom (taxable labor) for an existing business office in Houston, Texas. His invoice charges his customer for the following items under a lump-sum contract:

- Breakroom Remodeling: $152,000 (entire invoice taxable)
- Includes:
  - Materials
  - Labor
  - Meal Reimbursements
  - Fuel Reimbursements
  - Wait Time
- Subtotal: $152,000
- Sales Tax (8.25%): $12,540
- Total: $164,540

A taxable service provider must also charge tax on all charges made for the service when the charges are separately-stated under a separated contract. Comptroller's Example

Robert renovates an employee breakroom (taxable labor) for an existing business office in Houston, Texas. He invoices his customer for the following items, under a separated contract:

- Breakroom Remodeling:
  - Materials: $100,000 (taxable)
  - Labor: $50,000 (taxable)
  - Meal Reimbursements: $1,000 (taxable)
  - Fuel Reimbursements: $500 (taxable)
  - Wait Time: $500 (taxable)
- Subtotal: $152,000

- Sales Tax (8.25%): $12,540
- Total: $164,540

Amending Contracts

All parties to a contract may renegotiate it to alter the tax effects, so long as they do so before the contract is completed. A contract is completed when all parties have completely performed their obligations under the contract. After completion, the taxability of a contract is set and renegotiation will not alter the tax effects.[195]

Change Orders

The terms of the contract control change orders. If the contract is lump-sum, change orders will be treated as lump-sum, even if the change orders separately state the charges for labor from the other charges. If the contract is separated and the change order states a lump-sum amount, the entire amounts will be treated as a taxable charge for materials unless the contractor can show the amount attributable to labor.[196]

☞ ***Note:*** Comptroller policy is inconsistent as to whether change orders can alter the nature of the contract from lump-sum to separated, or vice versa. In one line of policy, the Comptroller holds that the terms of the contract control change orders.[197] If the contract is lump-sum, change orders will be treated as lump-sum even if the change orders show separately stated charges for incorporated materials.[198] If the contract is separated and the change order contains lump-sum amounts, the lump-sum amounts will be treated as if they are for materials unless the contractor can show the amount attributable to labor.[199]

☞ ***Note:*** But, the Comptroller has allowed a change order, addendum, or contract amendment to change the original contract from a lump-sum to a separated contract, and

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195 Comptroller Hearing No. 36,552 (1998) (STAR No. 9805610H) (citing to Comptroller Publication No. 96-237-T (revised 1992)).

196 *See* Comptroller Rule § 3.291(b)(5).

197 Comptroller Letter No. 200010769L (Oct. 6, 2000); Comptroller Letter No. 9209L1191B13 (Sept. 10, 1992) ("change orders will take on the same character as the original contract regardless of the form of the change order."); Comptroller Letter No. 9911840L (Nov. 1, 1999) (superseded on the issue of collection of local taxes) (Additional items added as a change order to an existing contract will be considered a lump-sum contract if the initial contract was lump-sum).

198 Comptroller Letter No. 200010769L (Oct. 6, 2000).

199 *Id.*

vice versa, if the addendum, change order, or amendment specifies that one of its purposes is to change the entire contract from one form to the other form.[200]

☞ ***Note:*** In another line of policy, the Comptroller has held that change orders, change directives, field authorizations, progress payment forms, and resale certificates may bear on whether a contract is lump-sum or separated.[201] For example, contract language that incorporates progress billings as a legally binding part of the contract can be sufficient to characterize the contract as lump-sum based on the terms of the contract and the progress billings.[202] In Comptroller Hearing No. 37,382, the Comptroller held that progress payment forms that separated the costs in accordance with the requirement of the contract language was sufficient to transform the lump-sum contract into a separated contract.[203] This line of policy is more consistent with general contract principles that govern construction contracts.[204] Texas case law has held that change orders that are consistent with the parties' contract and subcontract do not constitute separate agreements, but are instead modifications to the original contracts.[205]

Contracting Taxability

Sometimes the contract language purports to shift the tax responsibility from one entity to another. For example, a lump-sum contract specifies that the customer will be responsible for paying all Texas sales and use taxes. While such contractual agreements may be binding between the parties, the Comptroller's authority to impose and collect sales and use taxes arise from the applicable Tax Code provisions and not by agreements between private

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200 Comptroller Letter No. 9209L1196A13 (Sept. 24, 1992).

201 Comptroller Hearing No. 49,560 (2009) (Comptroller considered change orders, resale certificate, prime contract, and witness testimony regarding a missing schedule of values); Comptroller Hearing No. 24,582 (1992) (superseded on the issue of error rate for missing records) (Comptroller considered bid proposal); Comptroller Hearing No. 40,946 (2003) (Comptroller considered bid proposal, two applications for payment, and internal records including a check issued to contractor for the first draw); Comptroller Hearing No. 37,382 (1999) (Comptroller considered progress payment forms used during performance of the contract); Comptroller Hearing No. 40,445 (2002) (Comptroller considered schedule of values and revised bid proposals); Comptroller Hearing No. 17,985 (1987) (Comptroller considered schedules of value); Hearing No. 34,808 (1996) (Comptroller considered progress billings and bid proposals).

202 Comptroller Letter No. 9207L1182G12 (July 13, 1992).

203 Comptroller Hearing No. 37,382 (1999).

204 *Quantum Elec., Inc. v. Scott & White Props., Inc.*, No. 11–05–00355–CV, 2007 WL 3105757 (Tex. App.—Eastland, Oct. 25, 2007, no pet.).

205 *Id.*

parties. Although the customer may reimburse the contractor for sales and use taxes paid, the state does not recognize the customer's obligation to pay sales and use tax under a lump-sum contract.

Tax-Included Provision

In a properly drafted "tax included" provision, the buyer shifts the sales tax liability to the seller. The buyer can do this only by stating in the contract that "the stated price includes sales or use taxes."[206] This provision means that the agreed price includes the sales tax as one of its components, even though the sales tax is not separately-stated. Buyers must use the specific language, verbatim as recited above in order to create a "tax included" contract. No other language will do. *Perry Homes v. Strayhorn* illustrates his point.[207]

Perry Homes, a residential home builder, contracted to purchase taxable services in connection with its new construction of residential real estate. The auditor assessed tax on Perry Homes' payments to its subcontractors. Perry Homes filed a refund suit on the basis that its contracts with its subcontractors already included sales tax. Perry Homes supported its claim with contracts stating that its subcontractors would indemnify Perry Homes for any taxes due, including sales taxes. Perry Homes also offered evidence of letters it wrote to its subcontractors, confirming that their fees met all tax obligations.

The court determined that Perry Homes' contracts weren't tax included contracts because they didn't specify that "the stated price includes sales tax." To the contrary, the contracts and the letters to Perry Homes' subcontractors merely sought to indemnify Perry Homes from any tax due. Private parties may not simply "contract away" a sales tax obligation.

Comptroller's decisions have stressed that unless the taxpayer produces a written controlling document with sales tax-included language, the presumption is that sales tax is not included in the sales price. Contracts, bills or invoices stating that "all taxes" are included are not sufficiently specific to relieve either party to the transaction of sales and use tax responsibilities. The wording in the controlling document should state, "the stated price includes sales or use tax." Without this phrase, the total amount shown on the document is presumed to be the taxable item's sales price excluding tax. The seller or customer may overcome the presumption by using the seller's records to show that tax was included in the sales price. Out-of-state sellers must identify the tax as Texas sales or use tax.

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206 Comptroller Rule 3.286(d)(3).

207 108 S.W.3d 444 (Tex. App—Austin 2003, no pet.).

Collecting and Paying Taxes

The type of contact determines the sales tax responsibilities of the customer and contractor.

Lump-sum Contract Rules.[208]

- The contractor is considered the consumer of all materials physically incorporated into the realty.
- The contractor must pay sales tax on the purchase of incorporated materials.
- The contractor may not issue a resale certificate to purchase the materials.
- The contractor must pay sales tax on consumable supplies and all equipment bought, leased, or rented for use on the job.
- The contractor who also makes retail sales of materials may issue a resale certificate on purchases of inventory if he does not know at the time of purchase how the inventory will be used. The contractor must then accrue use tax on materials used in lump-sum contracts.[209]
- The contractor should not collect tax from the customer on the sale. If the contractor collects tax in error, the tax must be remitted to the state or refunded to the customer. Tax collected from a customer on a lump-sum contract project cannot be applied as a credit to offset a contractor's audit assessment because the tax was collected from the wrong party. The customer may appropriately claim a refund of the taxes it paid. The state should refund to the contractor the tax collected in error once the contractor issues either a refund to the customer or, if the customer accepts, a sales credit for the tax amount.

Direct Payment Customers. Contractors performing lump-sum contracts for entities holding direct payment permits may not accept a direct payment exemption certificate from those entities. When performing a lump-sum contract for a direct payment permit-holder, a contractor must pay sales tax to the supplier or accrue and remit sales tax on incorporated materials or materials removed from a tax-free inventory for incorporation into the direct payment permit-holder's realty. Direct payment permit-holders may not authorize contractors or any other person to purchase any taxable item using their permits.

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208 *See* Comptroller Rule 3.291.

209 Comptroller Letter No. 8608L0750C04 (August 22, 1986).

Separated Contract Rules.[210]

- The contractor is treated as the retailer of all materials physically incorporated into the realty.
- The contractor must collect sales tax from the customer based on the agreed upon contract price of the materials, or cost of the materials to the contractor, whichever is greater.
- The charge for labor is not taxable.
- The contractor may issue a resale certificate to purchase the materials.
- The contractor must pay sales tax on consumable supplies and all equipment bought, leased, or rented for use on the job.
- The local sales tax due on the materials is based upon where the job site is located.

Resale Certificates. A subcontractor performing improvements to realty under a separated contract may accept a properly-completed resale certificate from the general contractor.[211] In turn, the subcontractor may issue properly completed resale certificates to their suppliers of incorporated materials.[212]

Direct Pay Certificates. Purchasers who buy at least $800,000 of taxable items for their own use may apply for a permit that allows the purchaser to pay sales tax on the purchased items directly to the Comptroller. This is in lieu of having the seller of items collect the sales tax from the purchaser and remit it to the Comptroller. Direct payment holders may issue a direct pay certificate to contractors performing separated contracts. Contractors performing separated contracts are considered retailers of the materials incorporated and may accept resale or direct pay certificates from their customers on the charge for materials.

Equipment. A contractor must pay sales tax at the time of purchase, lease, or rental on the sales price of equipment used to perform a contract, including projects performed under contracts with exempt organizations and governmental entities. Equipment includes items such as cranes, scaffolding, paintbrushes, drilling bits, blades, and tools. A contractor must accrue and remit use tax on the sales price of equipment purchased, leased, or rented for

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210 *See* Comptroller Rule 3.291.

211 Comptroller Letter No. 9301L1218C07 (January 6, 1993).

212 *Id.*

use in Texas from an out-of-state seller unless the out-of-state seller collected Texas use tax.[213]

Rentals of equipment with and without operators:

- **Without operator.** Receipts from the lease of tangible personal property without an operator are taxable.
- **With operator.** The furnishing of tangible personal property with an operator for which a single charge is made to the customer is presumed to be the performance of a service and the contractor should not charge tax to the customer, unless Texas law classifies the service as taxable.

  This service presumption may not be rebutted solely by one party to the transaction. The service presumption may be rebutted by the following criteria which establish a lease of tangible personal property:

  - the customer exercised direct control or supervision over the operator of the tangible personal property; and
  - the intent of the agreement was to lease tangible personal property and separately furnish an operator.

Non-Permitted Contractors Purchasing Out-of-State. Purchasers of goods or taxable services from an out-of-state vendor, who does not collect Texas tax, owe Texas use tax.[214]

The Comptroller's office provides an "Occasional Use Tax Return" (form number 01-156) to use in paying any use tax on Internet or mail order purchases and on goods purchased while traveling out-of-state. The form may be completed online, printed and mailed with payment directly to the Comptroller.

The form is accessible at:

https://comptroller.texas.gov/taxes/sales/forms/

Maintenance

The charge for labor to maintain real property is not taxable. "Maintenance" is defined as

> "Work performed on operational and functioning tangible personal property that is necessary to sustain or support safe, efficient, continuous operation of

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213 Comptroller Rule 3.291(b).

214 *See* Texas Tax Code § 151.102.

> the tangible personal property, or is necessary to keep the tangible personal property in good working order by preventing decline, failure, lapse, or deterioration."[215]

To qualify as nontaxable, the labor must be scheduled, periodic work on operating and functioning improvements to real property that is necessary to sustain or support safe, efficient, continuous operations or to keep the improvement in good working order by preventing its decline, failure, lapse or deterioration.

This example illustrates the difference between a repair service and a maintenance service:

> *Example*
>
> Mr. Smith purchased an office building with a working air conditioning unit two months ago. He did not have time to determine the maintenance needs for the building. On May 25, 2017, the air conditioning unit began to make squealing noises while operating. Mr. Smith called a repairman and scheduled a visit for May 27th.
>
> The repairman lubricated the compressor for a lump-sum charge and got the unit operating quietly. This is a taxable repair service. Mr. Smith now realizes that he must perform periodic, scheduled maintenance to keep the air conditioning unit running smoothly. He asks the repairman how often the unit needs lubrication and is told every six months or 3,000 hours of operation, whichever comes first. Mr. Smith schedules in his building maintenance records the lubrication of the air conditioning unit every six months or 3,000 hours of operation. The subsequent lump-sum lubrication services performed to comply with the set maintenance schedule qualifies as maintenance. Therefore, the labor would be nontaxable, but the service provider is liable for tax on all materials used.

If the person performing the service does not have a written contract but is only hired as needed, the service provider must presume that the labor is for repair or restoration and charge tax. If the service provider's customer has documentation to prove that the labor qualifies as maintenance, the customer may issue an exemption certificate in lieu of paying tax to the maintenance service provider.

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[215] Comptroller Rule 3.292(a)(3).

The certificate must state that the labor is for the purpose of maintenance rather than repair or restoration and that the customer will be liable for any additional tax due in the event that it is determined that repairs rather than maintenance were performed.

Chapter V. Site Development

This Chapter applies the rules and principles discussed in the earlier chapters to the development of a typical neighborhood. Numerous tax issues arise at various phases of the construction work, from the initial development of the site, implementation of erosion control measures, the building of the utility infrastructures, construction of common areas and more.

Acquiring Land

The amounts paid to acquire land and existing improvements are not subject to sales tax. Texas imposes a sales tax only on the sale of tangible personal property and certain services. It is not imposed on the sale or rental of real estate (except motor vehicle parking charges).

Permit Fees

The application/permit fee is not subject to sales or use tax. The transaction between a city and a permit applicant is neither a sale of tangible personal property (TPP) nor a taxable service. Fees charged by a city to a contractor are not taxable when passed on to the customer, as long as they are separately-stated.

Engineers and Draftsman Services

A draftsman who produces a delineation, blueprint, or drawing based on specifications provided by a client is required to collect sales tax on the total price for producing the graphics, because it is a taxable sale of tangible personal property.[216] It does not matter what technology the draftsman uses to produce the graphics.

An engineer who creates an original design for a client using expertise and scientific engineering concepts such as principles of mathematics and physics provides a nontaxable service (*e.g.* calculation of load factors for stress points).[217] Although engineering services are generally not taxable, they may be taxable if they are part of another taxable service, such as engineering services performed as part of a remodeling job on a hotel.[218] Charges

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216 Comptroller Rule 3.312(a)(1); Comptroller Letter No. 9901204L (January 26, 1999).

217 Comptroller Letter No. 9901204L (January 26, 1999).

218 Comptroller Letter No. 8802L0862F13 (February 2, 1988).

for nontaxable engineering services should be stated separately for charges for taxable real property repair and remodeling.[219]

The essence of the transaction test applies to determine whether the customer contracted for engineering labor or tangible personal property.[220] Determining whether the essence of the transaction was labor or tangible personal property is a fact specific analysis.

Blueprints

Contractors are consumers of blueprint or design copies used for a contract to improve real property, even if the contractor separately states the charge for the copies to the owner of the real property. The contractor should pay sales tax on such copies regardless of the exempt status of the client. However, contractors must collect and remit tax on copies of plans sold to persons who are not parties to the construction contract.

For example, sales tax is due on a sale to a person who seeks copies of the plan in order to bid a project. The contractor must collect and remit tax on such sales and may issue a resale certificate for copies that are in fact resold.

When an agency relationship exists between a contractor and an exempt entity, any additional copies of blueprints or design copies that are requested by the exempt entity may be purchased tax free. The original set of blueprints or design copies purchased by the contractor would be subject to sales and/or use tax.

Land Clearing

Generally, clearing land for construction does not constitute taxable landscaping. However, removing trees in order to replant them is an arborist service and is subject to tax.[221] The landscaper/arborist may separately state non-taxable charges for construction clearing from taxable charges for removing and replanting trees and collect tax only on the taxable portion. [222]

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219 Comptroller Hearing No. 30,908 (1995) (STAR No. 9509323H).

220 Comptroller Letter No. 9901204L (January 26, 1999); Comptroller Hearing No. 9992 (1979) (STAR No. 7906308H).

221 Comptroller Letter No. 9804140L (April 22, 1998).

222 Comptroller Rule 3.356.

Surveying

Surveying activities may be performed for a number of reasons, some are taxable, some are not. A survey may be performed to determine or confirm the boundaries of real property. Or a survey may be performed to determine or confirm the location of structures or other improvements in relation to the boundaries of the property, using the relevant elements of law, research, measurement, analysis, computation, mapping and land description.

Examples of surveying include boundary recovery, residential surveying, lot surveying, title surveying, as-built title surveying, and right-of-way surveying. Taxable surveying does not include activities performed after taxable surveying has been completed to search the surveyed area for items of archaeological or historic significance.[223]

Taxable Surveying Services.[224] The charge for surveying is taxable when the work is performed to determine legal boundaries.

- **Title Survey.** Field work includes locating corners and boundary of lot with location of house. Office work includes computation, drafting of plats, and field note description.
- **Land Survey.** Field work includes locating property lines corners. Office work includes computation, drafting, and field note description. In some cases, it also includes a title search at a courthouse.
- **Boundary staking and referencing.**

  As built surveys.

  Lot surveys.

  Lot resurvey or update.

  Establish right-of-way and flag clearing limits for utilities.

  Establish lot line for control and clearing for dry utilities.

  Well locations-includes boundary survey to determine acreage of unit.

☞ ***Note:*** Determining lease boundaries is taxable; determining the location for a structure is not. A surveyor should separate the taxable and nontaxable charges, or the Comptroller will treat the total charge as taxable.

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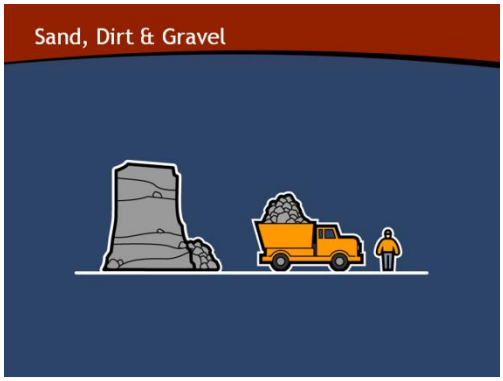
223 Comptroller Rule 3.356 (a)(9).

224 Comptroller Letter No. 8711L0844F11 (November 19, 1987).

Non-Taxable Surveying Services.[225]

- Running primary and secondary control (no boundary involved).[226]
- Running horizontal and vertical control (no boundary involved).[227]
- Centerline control staking and reference for utility layout, profile street (structure location).
- Topographic maps (while the service to create an original map is not taxable, subsequent sales of the map or copies are taxable).
- Tree surveys.
- Centerline staking for pipeline or route survey (structure location).
- Preliminary lot staking for utilities.
- Final lot staking.

Sand, Dirt and Gravel



Sand, dirt, gravel and similar materials are typically used in building sites, preparing drill sites and landscaping. These materials are subject to sales tax if they are sold in *processed* form.[228] However, persons who furnish, sell or deliver unprocessed sand, dirt and gravel are providing a nontaxable service.[229] Materials that are only washed or sorted are considered unprocessed.[230]

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225 *Id.*

226 A system of points whose relative positions have been determined from survey data.

227 Control station whose grid coordinates are known, established benchmarks.

228 Comptroller Letter No. 8909L0969G01 (September 6, 1989); Comptroller Letter No. 9212L1233B12 (December 7, 1992).

229 *Id.*

230 Comptroller Letter No. 9212L1233B12 (December 7, 1992).

- **Processed Materials.** Sales of processed materials are subject to the sales tax.[231] Processed materials include stone that has been crushed into smaller sizes and materials that are mixed with others, such as spud mud or ready-mix concrete.[232]
- **Ready Mix Concrete Contractors.** A "ready mix contractor" is defined as a person who manufactures or produces ready mixed concrete for construction purposes and incorporates the ready mixed concrete in the property improved.[233]

  "Ready mix concrete contractors" must separately state the price of the concrete incorporated into realty and invoice and tax the customer for each cubic yard of concrete produced and installed.[234] The sales tax rate in effect at the job site is applied to the greater of the actual invoice price of the component materials or the fair market value of the concrete incorporated into the project.[235]

  – This requirement does not apply to an invoice submitted by a ready-mix concrete contractor for a public works project.[236]

  – As a seller of taxable ready-mix concrete, the contractor may give a resale certificate in lieu of paying sales tax on materials such as processed sand, processed gravel, or processed aggregate used in mixing the concrete.
- **Stone Cutting.** The Comptroller considers equipment to qualify for the manufacturing exemption when it is used to extract rock from a quarry and break it into manageable pieces. However, the Comptroller determined that the company extracting the rock from the quarry must charge sales tax when it sells that stone to other manufacturers for further processing.[237]

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231 *See* Comptroller Letter No. 9104L1097G12 (April 2, 1991).

232 Id.

233 *See* Texas Tax Code § 151.056(g).

234 *Id.*

235 *Id.*

236 *See* Texas Tax Code § 151.056(g).

237 Comptroller Hearing No. 38,084 (2000) (STAR No. 200004567H).

Erosion Control

Cities and counties generally require that developers have erosion control measures in place when the developers begin to improve a tract of land. This is especially true for hillsides or canyons where erosion may be a significant problem.

At the outset, the contractor will dig sediment retention ponds and erect sediment containment fences along the longitudinal or contour lines of hills and canyons. As rainwater runs down the hills, these containment structures slow the flow of water, allowing the dirt in the water to settle and remain on the hill or canyon, rather than wash off. The sediment retention ponds are dug using large machines such as backhoes, bulldozers and graders. They are dug at the places designated on the engineer's blueprint drawings. Sediment containment fences "silt fences" are also erected to slow the flow of run-off water and channel it to the retention ponds or other drainage areas.

The silt fences are made of a polyester cloth that decomposes over time. The cost of the silt fence materials is very low in relation to the labor required to erect or install them. At the conclusion of the project, the unburied portions of the cloth are removed and usually discarded or buried. The steel pickets and wire used to hold the cloth in place are reused on other projects.

Another component of an erosion control service is the placement of soil retention blankets on hillsides. These blankets are stapled or secured to the earth and are porous so that grass can grow through them. The purpose of the blankets is to prevent soil from washing off of the side of hills.

Gabions and rock berms are other components of an erosion control service. These components slow the flow of run-off rainwater and allow debris to settle out. They, like the sediment retention fences, may channel run-off water to the sediment retention ponds. In addition to creating the rock walls or gabions, the erosion control may include spreading rock at the entrances and exits of the construction sites to prevent erosion caused by wheel ruts.

A developer's contract with the general contractor (the prime contract) typically contains one or more provisions stating that "control measures will be employed to prevent and control soil erosion, sedimentation and water pollution which may degrade rivers, streams, lakes, groundwater and wetlands."

Control measures may include:

- sediment control or silt fences,[238]
- rock filter dams,
- dikes,
- swales,[239]
- sediment traps and basins,
- pipe slope dams,
- paved flumes,[240]
- construction exits,
- seeding,
- sodding,
- mulching,
- soil retention blankets, or
- retention ponds.

238 Permeable barriers erected to capture sediment from sheet flow.

239 Vegetated channels used to convey storm water.

240 Small concrete-lined channels to convey water down a relatively steep slope without causing erosion.

Example:

Trout Creek runs across LandCo's new residential development project. Heavy rains erode the banks of Trout creek and flood low-lying areas in LandCo's development project. LandCo hires ABC Construction to perform erosion control services. ABC Construction will install gabions on the banks of Trout creek to reduce or prevent erosion during heavy rains. ABC will also construct a five-acre retention pond to hold and slowly release water from heavy rains. In order to reduce silt from washing into the creek ABC will install temporary inlet protection gabions and silt fences. ABC will also construct permanent inlet protection columns made of concrete to capture large debris before it enters the creek and drainage channels.

Before beginning work on the project ABC is required to install silt fencing around the area where ABC will perform its erosion control services. Soil retention blankets will also be installed on steep hillsides to prevent soil from washing into the creek.

Comptroller's treatment of erosion control measures:

- **Retention blankets** are treated as the sale and installation of tangible personal property because they are generally not intended to be a permanent improvement to realty.
- **Retention ponds** are treated as improvements to realty due to the intended permanence of the improvement.
- **Inlet protectors** are treated as improvements to realty if parties intended to for improvement to remain in place (*i.e.*, permanent concrete structures versus temporary gabions or silt fences that will be removed after construction is completed).

Temporary Inlet Protection.

Gabions are treated as improvements to realty due to the manner of attachment and fitness or adaptation to realty to which they are connected (*i.e.*, permanently affixed to creek bank).

Permanent Gabion in creek bed

Permanent Gabions

Permanent Gabion in Creek bed

Permanent Erosion Control.

Silt fences - Treated as rentals or the sale and installation of tangible personal property. Total charge to install and remove is taxable. In *Austin Engineering*, the Third Court of Appeals accepted the Comptroller's position that a lump-sum charge for the installation of silt fences and similar erosion control devices constituted the sale of tangible personal property, rather than a non-taxable service.[241]

Temporary Gabion and Silt Fence

[241] *Austin Engineering, Inc. v. Combs*, No. 03-10-00323, 2011 WL 3371557 (Tex. App.—Austin, August 5, 2011, no pet.) (mem. op.).

Temporary Gabion and Silt Fence

Temporary Silt Fence

Silt Fence in Creek Bed

Silt Fences Exemption Issues:

- If the silt fence is installed on highway right of way, the silt fence subcontractor may accept resale certificate from a general contractor performing services under a government contract.[242]

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242 Comptroller Letter No. 200309150L (September 18, 2003).

- Silt fencing on highway jobs are eligible for exemption as long as the component materials are not reusable after the construction project is complete.[243]

In an audit, the Comptroller will consider several factors to determine whether the fence is eligible for exemption:[244]

- Whether the fence is provided by a rental company (subcontractor) responsible for installing *and* removing it according to terms of a rental contract. If so, the fencing rental will not be eligible for the exemption.
- If the fencing was not rented, whether the taxpayer will reuse the silt fence components for another project, or whether the components will be abandoned or disposed of at the end of the project.
- Review the taxpayer's books and records to determine how actual purchases of fencing components are booked by the taxpayer.
  - In general, charging purchases of silt fencing to a particular project indicates that the components will not be reused and are therefore subject to the exemption.
  - In general, charging purchases of silt fencing to a general overhead or general inventory account may indicate that the items are reusable and not eligible for the exemption.
  - However, the taxpayer can still provide the Comptroller sufficient evidence to show that a fencing component was ultimately used on and not retrieved from a specific exempt job as an indicator that the item was not reused.
- Specific terms of exempt contracts may help determine whether new or used fencing components are required by contract.
- The "best source" of determining reusability is an actual visual identification of an inventory of used components at the job site or at a location used to store material that is maintained by the construction company.

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243 Comptroller Letter No. 201603709L (March 18, 2016) (citing *Austin Engineering, Inc. v. Combs*, No. 03-10-00323, 2011 WL 3371557 (Tex. App.—Austin, August 5, 2011, no pet.) (mem. op.)).

244 *See* Comptroller Letter No. 201603709L (March 18, 2016).

Roads & Utilities

A land developer will purchase a tract of land and subdivide it into individual lots with streets and utility easements. Then, the developer will hire utility companies to extend the electric, gas, telephone, cable service infrastructure to each of the individual lots. The utility companies, in turn, contract with utility contractors to lay buried conduit and cable for the utilities. In addition, the city, the county or the developer may contract to install infrastructure such as streets, curbs, gutters, water and wastewater lines.

"Dedicated and Accepted" Improvements

Neighborhood developers build the infrastructure, which generally consists of the streets, roads, sewer lines, etc. Upon completion, they will transfer ownership of the infrastructure to a governmental entity (such as a city) to maintain it.

The infrastructure is called "dedicated improvements" and is built to governmental entity specifications.[245] The governmental entity becomes the owner of these improvements and will be responsible for maintaining it when the development phase is completed.[246]

A contractor who improves realty for developers who, in turn, resells the improvements to a governmental entity may purchase materials incorporated into the property being improved, consumable items, and taxable items that are integral to the performance of a contract tax-free by issuing an exemption certificate.[247] This rule applies if the developer has a contract in place with the government entity. If the developer simply hopes to resell or transfer the improvements to a government entity, but does not have a contract in place, then tax will be due on the materials based on the type of contract: lump-sum or separated.[248]

Development Work. Development work refers to contracts with private parties to build public infrastructure, such as roads or sewer lines, which are dedicated to and will be accepted by a governmental entity. To qualify as an exempt contract, the private party must dedicate the realty and the improvements to the governmental entity before the work

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245 Comptroller Letter No. 9310L1271B10 (September 14, 1993).

246 *Id.*

247 *See* Texas Tax Code § 151.311.

248 Comptroller Letter No. 9310L1271B10 (September 14, 1993).

begins, and the governmental entity must accept or conditionally accept the realty and the improvements.[249]

Residential and New Commercial Construction

The charge for labor to construct a residential improvement to realty is not taxable.[250] Moreover, Texas does not impose sales tax on the labor used to build new improvements to non-residential realty, which includes model homes, club house and pool.

As we discussed in the earlier chapters, determining when and how to tax the tangible personal property involved in residential construction depends on the type of contract and the owner of the residence.[251]

Lump-Sum Contract. A lump-sum contract is one in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separate from the charges for skill and labor. Separated invoices issued to the customer will not change a lump-sum contract into a separated contract unless the terms of the contract require separated invoices.[252]

> *Example:*
>
> Dreamhome Homebuilders agrees to build a home for Nick and Nancy Newlywed. They execute a contract in which Dreamhome charges for $150,000 with no separately-stated the charge for the materials. This is a lump-sum contract.

Effects of Using a Lump-Sum Contract. Contractors performing lump-sum contracts are treated as the consumers of all materials, consumable items, and equipment used or incorporated into a customer's property. As a consumer, a contractor must pay sales tax to suppliers at the time the materials are purchased. If the materials are purchased from an out-of-state seller, a contractor must accrue and remit use tax on the materials unless the out-of-state seller collected Texas use tax. A contractor shall not collect tax from a customer on a lump-sum charge or any portion of the charge[253]

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249 Comptroller Rule 3.291(d).

250 *See* Comptroller Rule 3.357; Comptroller Letter No. 9310L1269D06 (October 27, 1993).

251 Comptroller Rule 3.291(b).

252 Comptroller Rule 3.291(a)(5).

253 Comptroller Rule 3.291(b)(3)(A).

Example:

Dreamhome Homebuilders buys lumber, nails, saws, hammers, glue, sawhorses, forklifts and other materials and equipment with which to build Mr. & Mrs. Newlywed's new house. As a lump-sum contractor, Dreamhome is the consumer of all of these items and, therefore, must pay sales tax to the vendors of all of these items. Dreamhome does not charge sales tax to Mr. & Mrs. Newlywed. (But Dreamhome may add the sales tax cost to arrive at its lump-sum price.)

Resale Inventory of Lump-Sum Contractors. When a lump-sum contractor incorporates materials from the resale inventory into a lump-sum contract, the contractor must accrue and remit tax based on the cost of the materials. The tax should be remitted to the Comptroller for the reporting period in which the materials were used. A contractor purchasing items specifically for use in a lump-sum contract may not issue resale certificates in lieu of tax for such items.[254]

Separated Contract. A separated contract is one in which materials charge is separately-stated from the other charges. If the contract states separate prices for materials and labor, the fact that the charges are added together and a sum total is provided is irrelevant; this will not convert it into a lump-sum contract. Cost-plus contracts are generally considered separated contracts.[255]

Example:

Dreamhome Homebuilders agrees to remodel the home of Mike and Midge Middleclass. They execute a contract to remodel the home for $80,000. The contract separately states that the $80,000 is comprised of $50,000 for materials physically incorporated into the remodeled home and $30,000 for labor. This is a separated contract.

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254 Comptroller Rule 3.291(b)(3)(D).

255 Comptroller Rule 3.291(a)(6).

Effects of Using a Separated Contract. Generally, contractors performing work under separated contracts are considered retailers of all materials physically incorporated into the realty being improved.[256] As a retailer, a contractor must collect tax from the customer based on the agreed contract price of the incorporated materials. Contractors performing separated contracts must hold sales tax permits and collect, report, and remit the tax as required by Comptroller Rule 3.286. Contractors purchasing materials specifically for incorporation into realty under separated contracts may issue suppliers resale certificates in lieu of tax. The purchase, rental, or lease of equipment for use in performing a nonexempt contract is subject to tax.[257]

Example:

Dreamhome buys nails, lumber, doors, windows, carpeting, insulation and other materials that it incorporates into the remodeled home of Mr. & Mrs. Middleclass. When Dreamhome buys these materials from its vendors, it may issue a resale certificate because it has a separated contract. When Dreamhome sells the materials to Mr. & Mrs. Middleclass, it must charge and collect sales tax on the $50,000 from them and remit the tax to the Comptroller. Dreamhome must pay sales tax on any equipment it purchases for use in remodeling the home.

Real Property Services Exception

Certain real property services are not taxable when purchased by a contractor or home builder as part of the improvement of real property with a new residential structure to be used as a residence or other improvement immediately adjacent to the new structure and used in the residential occupancy of the structure:

- Landscaping;
- Lawn care;
- Pest control;
- Surveying;
- Building and grounds cleaning; and

256 Comptroller Rule 3.291.

257 Comptroller Rule 3.291(b)(4)(A) and (B).

- Waste removal services.

☞ ***Important Note:*** A landscape contractor should ask for a letter from the contractor or homebuilder certifying that the work is for new residential construction prior to commencing work to reduce likelihood of a failed claim of exemption.

A landscape contractor should presume that the landscaping service is taxable and collect tax on the total charge until he obtains the proper certification.[258] If the contractor later determines that the work does not qualify as a nontaxable service then the person who issues the certification will be held liable for the tax.

Landscaping. Landscaping is the activity of arranging and modifying areas of land, natural scenery and other areas, such as indoor or outdoor patios, for aesthetic effect, considering the use of the land. The term includes adding, removing, or arranging natural forms, features, and plantings, including vegetation, and other features to fulfill **aesthetic** requirements. It includes the application of soil, soil additives, and amendments to prepare or maintain the planting area. Some examples are garden planting or maintenance, arborist services, ornamental bush or shrub planting, tree planting or removal, tree surgery, pruning or spraying, and lawn sodding.[259]

Landscaping does not include the installation of sprinkler systems, retaining walls, ponds, pools, or fences, or other construction activities or services provided by landscape designers or landscape architects such as consultation, research, preparation of general or specific design or detail plans, studies, specifications, or supervision, or any other professional services or functions within the definition of the practice of engineering or architecture.

Landscaping services performed by landscape designers or landscape architects are taxable.[260]

Taxable Landscaping Services.[261]

- Planting, transplanting, relocating and removing indoor or outdoor plants;
- Identifying, preventing or curing plant diseases;

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258 *See* Comptroller Letter No. 9709952L (September 18, 1997).

259 Comptroller Rule 3.356: Real Property Services.

260 Texas Tax Code § 151.0048; *See* Comptroller Rule 3.356; Comptroller Letter No. 200105212L (May 2, 2001).

261 Comptroller Letter No. 200105212L (May 2, 2001); Comptroller Publication No. 94-112 (May 2003), *available at* http://comptroller.texas.gov/taxinfo/taxpubs/tx94_112.html.

- Pruning, bracing, spraying, fertilizing and watering plants;
- Planting, mowing, trimming and edging grass or other ground cover;
- Planting and maintaining flower gardens; and
- Trimming, spraying, and maintaining trees.

Nontaxable Services.[262]

- Mowing pipeline or highway rights-of-way;
- Trimming trees away from power lines;
- Harvesting, cultivating, mowing and fertilizing farm or forest land; and
- Mowing cemeteries.

Exemption Certificates. The contractor or homebuilder may provide the certification using an exemption certificate form. The certificate should state that the improvement is new residential construction. Landscaping services are excluded from the definition of real property (taxable) services only when purchased by a homebuilder, developer, or other contractor responsible for the new construction contract. That means that a landscaper may not accept a certification from a homeowner, unless the homeowner is building his own home.

When the landscape contractor obtains the certificate, Texas law treats him as a subcontractor improving real property. The type of contract used will establish his tax responsibilities. The contract should always be in writing.

Under lump-sum contracts (that do not separate material and labor charges), the landscape contractor is considered the consumer of all the items purchased to complete the job. Tax is due on all purchases of taxable items. No tax is due to the customer.

Under a contract that separately states the charges for materials from labor the landscaper is considered a seller and must charge tax on the material charges only. Any local sales taxes are due based on the location of the job site. No tax is due on the charge for labor.

If the general contractor or homebuilder fails to provide a certification, the service will be treated as a taxable landscape service and sales tax will be due on the total charge for the

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[262] Comptroller Letter No. 200105212L (May 2, 2001); Comptroller Publication No. 94-112 (May 2003), *available at* http://comptroller.texas.gov/taxinfo/taxpubs/tx94_112.html.

job. In this case, the location of the landscaper's place of business determines the local tax rate.

Other Considerations for Contractors Using Both Contract Types

If a lump-sum contractor also sells taxable items over-the-counter or also performs separated contracts, he may maintain a tax-free inventory of items held for resale.[263] The contractor must accrue use tax on the cost of the materials removed from inventory for lump-sum contract work. Items purchased exclusively for resale may be purchased tax free by issuing a resale certificate to suppliers in lieu of tax. The contractor must hold a sales tax permit in order to issue a resale certificate, and must collect, report, and remit tax to the Comptroller when the items purchased for resale are sold.[264]

For a contractor who performs work under separated contracts, he may also maintain an inventory of materials for which tax was paid to suppliers at the time of purchase. If these materials are incorporated into realty under a separated contract or are sold over-the-counter, the contractor shall collect tax from customer based upon the agreed contract price of the materials. Tax is due and must be remitted to the Comptroller on any difference (mark-up) between the price paid by the customer and the price paid by the contractor.[265] Comptroller Rule 3.338 governs the allowance of credits for tax paid to suppliers.[266]

Resale of Taxable Services. Contractors performing separated contracts may issue to suppliers resale certificates in lieu of paying tax for taxable services that are resold to the contractor's customer. Examples of taxable services that may be resold are landscaping, surveying, and the final clean-up (janitorial services) of the construction site. Contractors may not issue resale certificates for a taxable service that the contractor uses and consumes, such as security services, telecommunications services, and daily janitorial services.[267]

> *Example:*
>
> Capitol Landscaping provides landscaping services to Dreamhome Homebuilders. Dreamhome may provide a resale certificate to Capitol

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263 Comptroller Rule 3.291(b)(3)(B).

264 Comptroller Rule 3.291(b)(3)(B).

265 Comptroller Rule 3.291(b)(4)(C).

266 *See* Comptroller Rule 3.338.

267 Comptroller Rule 3.291(b)(4)(E).

because it is reselling the landscaping services to Mr. & Mrs. Newlywed in remodeling their home. Private Eye Security provides security services to Dreamhome at the remodeling site while the remodeling occurs. Dreamhome cannot give a resale certificate because it is using the security services, and not reselling them to the Newlyweds.

Consumables. Generally, a contractor must pay sales tax on consumables it uses to perform construction contracts. Consumables are items that a contractor uses or consumes on a construction project, as contrasted with incorporated materials, which become a part of the real property. Consumables include items such as masking tape, corrugated cardboard, paint pot liners, steel strapping, sandpaper, and trash can liners. Consumables do not include items that are incorporated into real property such as mortar, bricks, nails, and caulk.

- **Exempt Consumables.** A contractor performing new construction or residential repair or remodeling under a separated contract may purchase consumables tax-free under the sale for resale exemption if the contract provides that title to the consumables will pass to the contractor's customer upon the contractor's receipt of the consumables and if the contractor does not use the consumables before title to them passes to the customer.
- **Exempt Customers.** Texas law exempts the purchase of tangible personal property (other than machinery or equipment, accessories, repair, and replacement parts) for use in performing a contract for an improvement to realty for exempt governmental entities, religious organization, educational organization, and public service organizations.[268] The tangible personal property must be necessary and essential for the performance of the contract and be completely consumed at the job site. The tangible personal property is completely consumed if is used up or destroyed after being used once for its intended purpose. The exemption does not apply to rented or leased items.

Examples of qualifying consumables include:

- welding rods,
- barricade tape,

[268] Texas Tax Code § 151.311 (This exemption applies to entities exempted under Texas Tax Code §§ 151.309 and 151.310).

- nonreuseable concrete forms,
- nonreuseable drop cloths,
- gas and electricity,
- plastic sheeting,
- survey stakes and flags,
- tape (except measuring tape),
- chalk markers,
- disposable brushes,
- form nails,
- street line "guides",
- blasting sand,
- tree markers,
- chalk line powder,
- disposable rags,
- form oil,
- masking tape,
- sandpaper, and
- welding gas.

Direct Pay Permit Customers. Contractors performing **lump-sum** contracts for direct pay permit holders may not accept a direct payment exemption certificate from those persons. When performing lump-sum contracts for a direct payment permit holder, the contractor must pay sales tax to the supplier or accrue and remit sales tax on the materials removed from a tax-free inventory for incorporation into the realty. Direct payment permit holders cannot authorize the contractor or any other person to purchase any taxable item using their permit.[269]

In contrast, contractors performing **separated** contracts may accept a direct payment permit exemption certificate from the permit holder in lieu of charging tax for all tangible

[269] Comptroller Rule 3.291(b)(3)(E).

personal property incorporated into the customer's realty. However, the certificate may not be accepted for tax due on machinery or equipment rented or leased by the contractor and used in the performance of the contract.[270] In general, contractors may not accept direct payment exemption certificates in lieu of tax for consumable supplies unless the following conditions are met:

- title to the consumable items transfers to the contractor's customer when the contractor takes possession or before;
- the consumable items are immediately marked, labeled, or otherwise physically identified as the customer's property, where practicable;
- the contractor separately states the charge for the consumable items to the customer and must collect sales tax from the customer unless the customer qualifies for exemption under Texas Tax Code §§ 151.309 or 151.310.[271]

Hybrid Contracts & Rebilled Services. A contractor may perform non-residential repairs and remodeling and not collect tax on charges for engineering and architectural services rebilled to its customers. In a Comptroller hearing, the contractor purchased the engineering and architectural services from third-parties and separately-stated the charges for the services on its invoices.[272] The contractor billed a lump-sum for the repairs and remodeling. The contractor properly treated the rebilled charges for engineering and architectural services as non-taxable and properly collected sales tax on the repairs and remodeling charge.

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270 Comptroller Rule 3.291(b)(4)(D).

271 Comptroller Rule 3.291(b)(2)(B).

272 Comptroller Hearing No. 101,939 (June 29, 2011) (STAR No. 201106189H).

Common Areas

The Comptroller defines residential property as:

"Property that is used as a family dwelling, a multifamily apartment or housing complex, nursing home, condominium, or retirement home. The term includes homeowners association-owned and apartment-owned swimming pools that are for the use of the homeowners or tenants, laundry rooms for tenants' use, and other common areas for tenants' use."[273]

Comptroller guidance limits residential common areas to those that are for "the sole use of the residents."[274] Therefore, under Comptroller policy, the sales tax rules applicable to HVAC services on condominium living quarters also govern HVAC services for residential common areas exclusively used by tenants. For example, a taxpayer would not collect tax on its charge to install an HVAC system in a condominium's tenant laundry room if billing lump-sum. If the taxpayer separately-states its labor and material charges, the taxpayer would only collect tax on the materials.

However, different rules apply to areas in a residential structure that may be accessed by both tenants and the public. Under Comptroller rule 3.357(a)(13), "[c]ommon areas of mixed residential and nonresidential property are allocated or prorated based on the ratio of residential to nonresidential use of the property. The term [residential property] does not include any commercial area open to nonresidents, retail outlets, hospitals, hotels, or any other facilities that are subject to the hotel occupancy tax." Therefore, [t]he charge for repair, restoration, or remodeling to common areas of mixed residential and nonresidential property is taxed based upon the ratio of residential to nonresidential use of the property."[275] For example, "if a golf course qualifies as a residential common area, but there is a retail outlet such as a pro shop or restaurant on site, then work to remodel, repair or restore the property should be prorated accordingly."[276]

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273 Comptroller Rule 3.291(a)(12); *see also* Comptroller Rule 3.357(a)(3) (containing substantially similar language).

274 *See*Comptroller Hearing No. 106,773 (2013) (STAR No. 201311837H) (Hearing Decision stating that residential property "includes common areas that are solely for the use of residents."); Comptroller Letter No. 200711067L (November 12, 2007) (letter ruling recognizing hallways as a tenant common area).

275 Comptroller Rule 3.357(b)(6).

276 Comptroller Letter No. 201206481L (June 28, 2012).

Further, "[r]epair, restoration, or remodeling that is performed upon a structure that is used both for residential and commercial purposes is taxable in total unless the labor on the residence is separately identified. The labor to repair, restore, or remodel the residence will not be taxable if separately-stated."[277]

In a Comptroller hearing decision, a taxpayer challenged the Comptroller's treatment of its services for a condominium project as taxable nonresidential (commercial) repair and remodel.[278] There, the taxpayer converted a nursing home into a condominium complex. Although the condo owner originally planned to sell all units as residences, the subsequent economic downturn led to the owner selling 204 units as residences and using 32 units for short-term rentals. Finding that the taxpayer failed to "distinguish services that were performed for residential areas from those that were performed for commercial areas," the Comptroller upheld the assessment of tax on the entire condominium project, citing Comptroller Rule 3.356(b)(6). Id. The Comptroller bolstered the decision by citing to his ability to treat a single charge as taxable if the taxable portion represents more than 5% of the total charge and the fact that prior Comptroller guidance has "held that if any of the individual units in a condominium development was commercial at any time during the year, then the entire repair and remodeling project was commercial and subject to tax."[279]

☞ ***Important Note:*** Given the potential applicability of the above rules, the prudent course of action is for the taxpayer to separately bid and bill work on any areas that could be construed as commercial to limit the Comptroller's ability to treat a mixed charge as entirely taxable. This segregation of residential and commercial work would occur in advance and independently of the decision to bill lump-sum or separated.

Problem Areas for Contractors

JAM Construction Company operates a business providing nontaxable construction services. By law, these nontaxable construction services are either residential construction or commercial new construction.[280] In conducting its business, JAM wants its customers to pay the sales tax on the materials it purchases and uses in performing a construction job.

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277 Comptroller Rule 3.357(b)(6).

278 *See* Comptroller Hearing No. 106,773 (2013) (STAR No. 201311837H).

279 *See id.* (citing Comptroller Letter No. 9306003L (June 1, 1993), formerly accession number 9306L1240B10); *see also* Comptroller Rule 3.357(b)(7), (8).

280 Texas Tax Code § 151.0047.

First Pitfall. JAM purchases its materials tax-free using a resale certificate. JAM then performs its construction work under a "lump-sum" contract, which means that JAM's contract with its customer sets forth single charge for the job; it does not separately state the charges for material from the charges for the labor.[281] JAM then erroneously charges its customer a separate amount for the sales tax on the cost of the materials it purchased, and reports and pays this sales tax to the Comptroller.

If JAM proceeds in this manner, JAM owes sales tax on the materials it purchased because the law considers JAM to be the consumer of those items when it performs its work under a lump-sum contract.[282]

Further, JAM will not receive credit against the liability for the amount of sales tax it had collected from its customer and paid to the State because the customer owes no sales tax on a lump-sum charge for any type of residential or commercial new construction work.[283]

☞ ***Note:*** Even though JAM cannot receive any credit for the sales tax it collected and paid to the State, tax collected in those circumstances must always be paid to the State. A seller who receives any amount collected as a tax or represented to be a tax, whether owed or not, holds that amount in trust for the State. Additionally, JAM may be subject to the fifty (50) percent penalty for willful failure to remit the collected tax.[284]

☞ ***Additional Note:*** In an audit, the Comptroller may claim the right to receive amounts collected as other states' sales or use taxes if those amounts have not been paid to the states or refunded to the customers.

Second Pitfall. JAM pays sales tax to its vendor on materials, and then charges a lump-sum price to its customer. JAM also separately charges and collects sales tax on the materials portion of its charge and keeps the sales tax as reimbursement for the tax it originally paid to its vendor.

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281 Texas Tax Code §151.056 and Comptroller Rule 3.291(a)(5) and (6).

282 Texas Tax Code §151.056(a) and Comptroller Rule 3.291(b)(3)(a).

283 Comptroller Rule 3.291(b)(3)(a) and Comptroller Hearing No. 34,808 (1996) (STAR No. 9605H1410E01).

284 Texas Tax Code § 111.016.

JAM will have the same problem. JAM cannot retain any sales tax amounts it collects regardless of the purpose behind the collection, including reimbursement. Again, JAM may be assessed the fifty (50) percent penalty.[285]

Third Pitfall. The customer gives JAM a direct-payment exemption certificate in lieu of paying JAM the tax due on the materials JAM purchased tax-free as a sale for resale. The customer assures JAM that it will pay the sales tax directly to the Comptroller.[286]

The Comptroller will not accept the direct payment exemption certificate and will assess sales tax against JAM on its purchase of materials because under the lump-sum contract, there is no taxable item being sold to the customer for the certificate to apply to.[287] Comptroller Rule 3.288(f) states: "Direct payment exemption certificates may be issued to contractors performing separated contracts."

Avoiding the First and Second Pitfalls. As a lump-sum contractor, JAM can avoid the first two mistakes by paying all sales taxes owed to its materials vendors. JAM is the consumer of these materials under a lump-sum contract. JAM may then include the cost of the sales taxes paid to its vendors as an item of overhead in the lump-sum price it charges its customer. The amount JAM recovers in this manner should not be shown as a separate line-item charge to the customer.[288]

Resolving the Third Pitfall. Here, JAM should never accept a direct payment exemption certificate in lieu of the sales tax under a lump-sum contract.

Resolving All Three Pitfalls. Alternatively, JAM may use a separated contract, setting forth separated charges for the construction labor from all other charges.

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285 Texas Tax Code § 111.016 and Comptroller Rule 3.291(b)(3)(a).

286 The holder of a direct payment permit gives a blanket exemption certificate to sellers who sell, lease or rent taxable items to the permit holder. This blanket exemption certificate covers all future sales of taxable items to the permit holder and relieves the seller of the duty to collect the sales taxes from the permit holder. Besides stating the direct payment permit number, the blanket exemption certificate must state that the permit holder agrees to accrue and pay all sales taxes to the State that may be due on the taxable items sold to the permit holder under the exemption certificate. *See* Texas Tax Code § 151.417. Comptroller Rule 3.288 specifies that a direct payment permit holder must purchase annually at least $800,000 worth of taxable items for the person's own use and not for resale.

287 Comptroller Rule 3.291(b)(3)(E).

288 Comptroller Rule 3.291(b)(3).

When JAM does this, it may purchase its materials tax-free under a resale exemption. JAM may then collect sales tax from its customers on the separately-stated charge for materials and pay it to the State, or it could accept a direct payment exemption certificate from a qualified permit holder.[289]

☞ ***Note:*** Even if JAM uses a separated contract, it will still be considered the consumer of all supplies and equipment (saws, sawhorses, lathes, scaffolding, etc.) it uses to perform a construction job.

☞ ***Additional Note:*** In certain instances, JAM may purchase the supplies tax-free. JAM may do so when title to the supplies transfers to the customer before the contractor takes possession of the supplies, and the supplies are immediately labeled as the customer's property if practical to do so. In this case, the consumables may be purchased tax-free for resale, so long as a separated contract is used.[290] But equipment purchased and used by a contractor can never be considered as resold to the customer.[291]

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289 *See* Texas Tax Code §151.417; Comptroller Rules §§ 3.288 and 3.291(b)(1).

290 Comptroller Rule 3.291(b)(1).

291 *Id.*

Chapter VI. Commercial Property Repairs and Remodeling

All charges, including labor incurred in connection with commercial real property repair, remodeling and restoration are taxable.[292] Commercial structures are non-residential real property structures where people generally do not live 30 consecutive days or more. They include office buildings, warehouses, stores, theatres, roads, oil wells, golf courses, hospitals, prisons, and so forth. Remodeling is making over, rebuilding, replacing, or upgrading existing real property. Repair means to mend or bring back as near as can be to its original working order real property which was broken, damaged or defective. Restoration is an activity performed to bring back as near as can be to its original condition real property which is still operating and functional but that has faded, declined or deteriorated.

Tax Consequences

The entire charge for repairing and remodeling commercial properties is taxable, regardless of the type of contract.[293]

Repairmen or Remodelers of Commercial Property. All persons who repair, restore, or remodel nonresidential real property must collect tax on the total sales price to their customers, less separately-stated charges for unrelated services. In the alternative, they may accept valid resale, exemption, or direct payment exemption certificates in lieu of tax. If the contract is for repairing or remodeling nonresidential realty, there is no tax distinction for the customer between a lump-sum or separated contract. All persons who repair, restore, or remodel nonresidential real property must obtain a Texas sales and use tax permit.[294]

> *Example:*
>
> Rock Construction Company executes a lump-sum contract to remodel the law offices of Lennon & McCartney for $200,000. Rock must charge and collect sales tax on the sales price of $200,000 from Lennon & McCartney. Even if the contract between Rock and the law firm separately-stated the $200,000 as $125,000 for materials and $75,000 for labor, the total price $200,000 would still be taxable.

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292 Comptroller Rule 3.357.

293 Texas Tax Code §§ 151.0101(a)(13) and 151.0047.

294 Comptroller Rule 3.357(b)(1) and (2).

Materials and Supplies

Material Purchases. Persons performing taxable repairs and remodeling may issue resale certificates when purchasing items to be incorporated into the job.

Sales Taxes Paid by Repairman or Remodeler. A repairman or remodeler must pay sales taxes on supplies that are used but not incorporated into the realty. The repairman or remodeler is not entitled to a credit for the tax paid on supplies used but not incorporated into the realty.[295]

> *Example:*
>
> Tool Guy Remodeling Company purchases hammers, screwdrivers, levels and work gloves from Home Depot to use in a remodeling job for Martin & Lewis, a CPA firm. None of these supplies are incorporated into the remodeled realty. Tool Guy must pay sales tax on these purchases to Home Depot, and it will not be entitled to a credit for these sales.

Mixed Contract for Remodeling and New Construction. The entire charge for nonresidential remodeling and new construction will be taxed unless the charge for new construction labor is separately-stated.[296]

> *Example:*
>
> Rock Construction Company remodels Underwood Barbecue's kitchen at the same time that it adds a new dining area outside the existing structure. Work on the kitchen is taxable remodeling, while work on the new dining area is new construction. The entire contract amount is taxable unless the charge for the new construction work is separately-stated. However, minor repair, restoration, or remodeling done in connection with new construction is not taxable if the charge for the repair, restoration, or remodeling work is 5 % or less of the overall charge.

Repairs v. Maintenance

Repair. The Comptroller defines repair as mending or bringing back real property as near as can be to its original working order. The real property must have been broken, damaged,

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295 Comptroller Rule 3.357(b)(4).

296 Comptroller Rule 3.357(b)(3).

or defective. However, minor repair work performed on operational and functioning improvements to realty that is deemed to be maintenance is not a taxable repair.[297]

Maintenance. "Maintenance" of real property is not considered repair, restoration or remodeling of real property. Again, the distinctions can be very slight. Maintenance is defined as the scheduled, periodic work necessary to sustain or support safe, efficient, continuous operations or to prevent the decline, failure, lapse or deterioration of the improvement. The key element is "scheduled and periodic." The maintenance work must be contemplated and scheduled prior to the need for the work. As a rule of thumb, if work is done after the property has failed, it is considered repair. If you are working on it to prevent failure, it is probably maintenance.

Scheduled. Scheduled maintenance work means such work that is anticipated and designated to occur within a given time period or production level.

Periodic. Periodic maintenance work (that is also scheduled) means work that is ongoing or continual or at least occurring at intervals of time or production that are generally predictable.[298]

Tax Responsibilities of Persons Performing Maintenance. A person performing maintenance work on realty does not have to charge and collect sales tax on charges for labor involved in the maintenance work. The sales tax treatment of tangible personal property, such as materials, supplies, and equipment related to the maintenance work will generally be the same as described above for contractors performing residential construction.

Example

An elevator company signs a maintenance contract with a building owner to periodically inspect and maintain the building's elevator and to repair it if it ever breaks down. The inspections are included in the maintenance contract price. However, major repairs are billed as needed. The fee for the maintenance contract is scheduled and periodic

297 Comptroller Rule 3.357(a)(9).

298 *Id.*

maintenance of real property, and hence not taxable. Although the inspections may necessitate minor repairs, this does not rob the contract of its maintenance status. However, once the company charges the building owner for a major repair after the elevator breaks down, it has performed services outside maintenance unless such fees were included and contemplated by the original contract.

Example

The Comptroller determined that railroad tie replacement services were real property repairs and not scheduled and periodic maintenance because, although the rail line regularly scheduled inspections of track segments, they only replaced the defective and damaged ties.[299]

Materials Incorporated into Construction Projects. Unless an exemption applies, materials incorporated into the repair and remodeling of commercial real property are taxable to the owner. It does not matter if the contract is lump-sum or separated.

Painting

Painting real property is an improvement to real property.[300] If a new residential or nonresidential building is painted (new construction), or if a residential building is repaired or remodeled by being painted, then the painting labor is not taxable.[301]

If an existing nonresidential building is repaired or remodeled by being painted, the labor is taxable because it is a taxable service. Painting is presumed to be a taxable restoration or remodeling activity unless it meets the definition of "maintenance."[302] Under Comptroller Rule 3.357(a)(7), maintenance is defined as "scheduled, periodic work that is necessary to sustain or support safe, efficient, continuous operations, or to prevent the decline, failure, lapse, or deterioration of the improvement. . . Maintenance does not include work to remodel, modify, upgrade, perform major repair, or restore, even if the work is scheduled or periodic."

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299 Comptroller Hearing No. 41,840 (2003) (STAR No. 200306015H).

300 Comptroller Letter No. 9502L1335A05 (February 16, 1995).

301 *Id.*

302 Comptroller Hearing No. 32,236 (1996) (STAR No. 9603144H).

Mixed Services

Generally, when a contract contains a single charge for both taxable services and non-taxable or exempt services or items, the total charge is taxable.

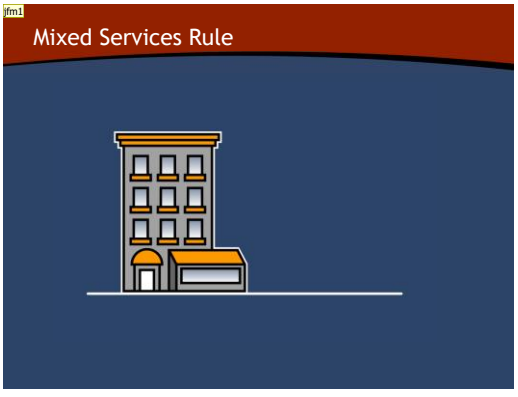
However, for certain specified services,[303] if a nontaxable "unrelated" service and a taxable service are purchased for single charge and the portion of the fee relating to the taxable services represents more than five percent (5%) of the total charge, the entire fee is presumed to be taxable.[304] A business may overcome this presumption by showing, through its books, a reasonable and proper allocation of its charges between the taxable and non-taxable portions of its charge. The business must also show that the non-taxable services are "unrelated."

A service is unrelated if it is not a taxable service; it is a type of service which is commonly provided on a stand-alone basis; and the performance of the service is distinct and identifiable.

In *Chevron Pipeline Co. v. Strayhorn*,[305] a pipeline company purchased excavation and backfilling services in connection with the repair and recoating of its underground pipelines. The underground pipelines could not be recoated without excavating and backfilling and the pipeline company never contracted solely for excavation and backfilling services. The same contractor performed all the services. The court determined that these were not unrelated services because the performance of the service was not distinct and identifiable.

Example

A building is adding a new wing, connecting it with an archway to the old building. The service provider charges a single fee of $100,000 to complete the work. If more than $5,000 of the work is attributable to demolishing the old wall and adding the archway, the entire $100,000 will be presumed taxable. It will then be up to the taxpayer to show a



303 Only the services that became taxable after October 1, 1987 qualify.

304 Comptroller Rule 3.357(b)(3).

305 *Chevron Pipeline Co. v. Strayhorn*, 212 S.W.3d 779 (Tex. App.—Austin 2006, pet. denied).

reasonable allocation to taxable/non-taxable portions based upon work sheets, bids or costs.

Note that if the portion of the charge relating to the nontaxable unrelated service is separately-stated, then only the taxable service is subject to tax. In general, the Comptroller allows this allocation for the services which became taxable after October 1, 1987.

Pipeline Construction and Repair

Texas sales tax treatment of labor charges in connection with constructing, relocating, repairing, replacing, removing, or demolishing underground natural gas pipelines depends upon the circumstances.

Nontaxable New Construction. The Comptroller treats as nontaxable the charges for labor for: (1) placing a new pipeline in a new trench to the left or right of an existing pipeline; (2) constructing a new pipeline in a new trench that is "substantially" deeper than the trench of an existing pipeline (depth of new pipeline is at least one-third greater than the depth of existing pipeline); and (3) placing a new pipeline in a new trench that is substantially shallower than an existing pipeline.

Nontaxable Demolition. The Comptroller treats as nontaxable the following labor charges because the work constitutes the complete demolition of an existing pipeline: (1) removing the existing pipeline from a trench before constructing a new pipeline at a depth that is at least one-third greater than the depth of the existing pipeline; and (2) filling an existing pipeline with concrete in order to abandon the pipeline.

Taxable Nonresidential Real Property Repair. These labor charges are taxable as nonresidential real property repair or remodeling: (1) replacing an existing pipeline with a new pipeline at the same depth; (2) excavating and lifting out an existing pipeline from the trench in connection with replacing it; (3) inserting a new pipeline inside of an existing pipeline; (4) connecting a new pipeline to an existing pipeline; and (5) capping the ends of an existing pipeline in order to abandon the pipeline in place.

Miscellaneous Work. The charges for excavating and removing nonoperational pipe and moving it to the service yard or to a recycler are taxable as a real property service.

A contract involving both taxable tie-in labor and nontaxable new construction labor is presumed to be taxable if the tie-in labor represents more than 5% of the total charge, unless the charge for new construction labor is separately-stated.[306]

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[306] Comptroller Letter No. 201706007L (June 26, 2017).

Chapter VII. Tax-Exempt Jobs

There are tax exemptions for governmental and specific exempt entities. The qualifying exempt entities include governmental entities and religious, educational and public service organizations.

A contractor performing a job for an exempt entity should obtain a properly completed exemption certificate to substantiate the exemption. If the validity of the exemption is not clear, a contractor cannot accept the exemption certificate in good faith and should request additional evidence of the exempt status of the organization. A sales tax letter of exemption from the comptroller addressed to an organization is evidence of its exempt status and will relieve a contractor from having to investigate or inquire further. A sale is exempt if the exemption certificate is accepted in good faith at the time of the transaction and the seller lacks actual knowledge that the claimed exemption is invalid.

Exempt Purpose of the Entity

An exempt entity must be contracting for a job that is related to the primary purpose of the exempt entity to retain the exemption. Where the primary use and benefit of the job is unrelated to the primary purpose of the exempt entity, the exemption does not apply.

Exempt Entity Proof

The contractor or subcontractor must verify that the exemption applies. A contractor may not simply rely upon an exemption certificate provided by the owner/alleged exempt entity or the general contractor. Under Comptroller Rule 3.291(c)(2)(A):

> "if the comptroller subsequently determines that the organization is not exempt, then the contractor [this includes the taxpayer as a subcontractor] is liable for all taxes, penalties, and interest that accrue upon [its] purchases."

The Comptroller imposed this harsh consequence where the subcontractor received a properly completed exemption certificate from a reputable general contractor, who repeatedly assured the subcontractor that the owner was exempt.[307]

Taxpayers may obtain "a letter of sales and use tax exemption from the comptroller that is addressed to the customer" through the Comptroller's website:

> https://comptroller.texas.gov/taxes/exempt/search.php.

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307 Comptroller Hearing No. 32,297 (1995) (STAR No. 9503H1344C04).

However, as noted in the website disclaimer, not all entities are required to apply for and receive notification of exempt status with the Comptroller.

Non-governmental Exempt Entities. Non-governmental entities, such as non-profits must apply, but governmental entities are not required to do so.[308] For example, a search of the Comptroller's directory reveals the exemption status of the City of Austin (and you can retrieve the Comptroller's verification letter), but a search for the City of San Marcos returns no results.

Therefore, we advise that contractors send emails or letters to the general contractor or the exempt entity asking if it has other documentation of the exempt status. The best practice is to seek an exemption certificate executed by the exempt organization itself. Although, it appears that an exemption certificate executed by the general contractor that references the work for the exempt organization could also protect the taxpayer if the entity is indeed exempt.[309]

Governmental Entities. Governmental entities are not required to prove their exempt status. A contract with a governmental entity is sufficient to invoke the exemption.

If the exemption certificate is not accepted in good faith at the time the contract was entered into, or if the customer is subsequently determined to be taxable, the contractor will be liable for all taxes, penalties and interest accruing on purchases for which the contractor has issued exemption certificates to its vendors.

Tax Consequences

When the contractor accepts an exemption certificate in good faith from qualifying exempt entities, the contractor can issue an exemption certificate in lieu of paying sales tax on charges for incorporated materials, qualifying consumables, qualifying taxable services, and gas & electricity. Qualifying exempt entities include governmental entitles (Section 151.309) and Religious, Educational, and Public Services Organizations (Section 131.310).

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308 Comptroller Rule 3.322.

309 *See* Comptroller Rule 3.291(a)(5) (an example of an "exempt contract" is "a contract with a nonexempt entity to improve real property for the primary use and benefit of an organization exempted under Texas Tax Code § 151.309 . . . ."); Comptroller Letter No. 9902452L (February 27, 1999) ("If [the subcontractor's] contract is not directly with the exempt organization, then [the subcontractor] must obtain an exemption certificate from the general contractor claiming that the material is being incorporated into the realty for the exempt organization.") (partially superseded on other grounds).

Incorporated Materials. Incorporated materials are tangible, personal property that become part of the real property improvement.

Material incorporated into real property for an exempt organization is exempt regardless of whether the contract's pricing is separated or lump-sum. If the exempt entity is a governmental agency, a purchase order issued by a governmental agency is sufficient to document the exemption. All other exempt entities must provide valid exemption certificates to claim the exemption.[310]

If you're performing work as a subcontractor under a lump-sum contract, you will not be contracting directly with the exempt organization. In this instance, you must obtain an exemption certificate from the general contractor stating that the material will be incorporated into the realty for the exempt organization. You may then issue an exemption certificate for the materials you purchase that you incorporate into the exempt entity's realty.[311]

If you're performing work as a subcontractor under a separated contract, again, you will not be contracting directly with the exempt organization. In this instance, the general contractor may issue a resale certificate to you. This applies to both new construction work and repairs and remodeling of reap property.[312]

Consumables. Consumables are items of tangible, personal property that do not become part of the real estate, but instead are used up at the construction site. A consumable item is exempt if it is:

- necessary and essential for the performance of the contract; and
- completely consumed at the job site.

Tangible personal property is completely consumed if, after being used once for its intended purpose, it is used up or destroyed. Tangible personal property that is rented or leased for use in the performance of the contract cannot be completely consumed for purposes of this section.

Services. A contractor may issue an exemption certificate for an otherwise taxable service if the service is performed at the job site and:

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[310] Comptroller letter no. 9902452L (Feb. 27, 1999) partially superseded on other grounds.

[311] Id p. 1.

[312] Id p. 1.

- the contract expressly requires the specific service to be provided or purchased by the person performing the contract; or
- the service is integral to the performance of the contract.

Electricity and Natural Gas. Electricity and natural gas used at the job site to operate power tools necessary to shape or fit materials into the finished project; furnish power for electric welding machines used in welding steel beams; and furnish power for other tools and equipment used directly in the construction of a project of an exempt customer is exempt from the sales tax.

Tax is due on all other uses of natural gas and electricity, such as lighting and heat in the trailer at the construction site.

These exemptions apply regardless of whether the contract is separated or lump-sum.

The contractor must pay tax on machinery or equipment and its accessories as well as repair and replacement parts used in the performance of the contract.

Exemption Certificates Requirements. A valid exemption certificate contains:

- the name and address of the purchaser;
- a description of the item to be purchased;
- the reason the purchase is exempt from tax;
- the signature of the purchaser and the date; and
- the name and address of the seller.

There is no provision in the sales and use tax law for an exemption number or a tax-exempt number to be issued or used in connection with an exemption certificate.

An exemption certificate must be in substantially the same form of a Texas Sales and Use Tax Exemption Certification that the Comptroller adopts.

Exempt Entity Examples

A charity hospital is an exempt entity. If the charity hospital builds a fitness center for use as an integral unit in the cardiac rehabilitation program and for the practice of preventive medicine, the fitness center fulfills the exempt purpose.

Therefore, the charity hospital could issue an exemption certificate to the contractor building the fitness center.

The purpose of an exempt entity is to raise money for cancer research. The entity builds an office building to lease to the public. Since the purpose of the entity is to raise money, building the office building would be exempt, and an exemption certificate could be issued.

A charity hospital is an exempt entity. The charity hospital builds an office building to lease to the public, not to doctors with hospital privileges. The office building does not fulfill the exempt purpose. Therefore, the charity hospital could not issue an exemption certificate to the contractor.

The purpose of another exempt entity is to provide after- school activities to under-privileged children. The board of directors decides to build an apartment house so they can rent to their employees. Renting apartments is not related to the exempt purpose; thus, the exemption is lost.

Building Owned by a Taxable Entity and Leased by an Exempt Entity.

If a taxable entity owns a building that is leased to an exempt entity, the exemption is applicable if the life of the lease equals or exceeds the life of the improvement to realty. If a lease between the owner and the exempt entity is for a set time period and the exempt entity has the option, but is not contractually obligated to renew the lease, the option is not considered when determining if the exemption applies.

Exempt Example

The life of the lease is 20 years. A renewed contract (a new lease) can extend the time of use for another 20 years to 40 years. The planned improvement appears to have an anticipated life of 20 years. The initial contract is equal to the expected life of the improvement to realty; therefore, the contract is making an improvement to realty for the exempt entity and qualifies for the exemption.

Taxable Example

The life of the lease in question is nine years. A renewed contract (a new lease) can extend the time of use for five more years to 14 years. The planned improvement appears to have an anticipated life of more than 10 years. The initial contract is less than the expected life of the improvement to realty; therefore, the contract is making an improvement to realty for the building owner and does not qualify for the exemption.

Development Work or Dedicated Improvements

Development work means improving real property for a private party who intends to donate the improvements to a governmental entity. Dedicated improvements generally include streets, roads, sewer lines, water lines etc. that are built to governmental entity specifications. When the development phase is completed, the governmental entity takes ownership of the improvements and becomes responsible for their maintenance. The contractor performing the work for the developer may claim an exemption from tax on certain purchases when specific conditions are met:

- The developer must have irrevocably dedicated the realty and improvements to the governmental entity.
- The governmental entity must have conditionally or unconditionally agreed to accept the realty and the improvements at a future date.
- This dedication and acceptance must take place before the work begins for exemptions to apply. If the work begins before the dedication and acceptance occur, the exemptions will not apply. Exemptions may be claimed from the time of dedication and acceptance forward.

The governmental entity must record its decision to accept the realty and improvements in the minutes of the meeting when the decision is made, and the appropriate maps or plats must be filed.

A contractor must presume that a contract with a private party (developer) is not an exempt contract. This presumption may be overcome by the contractor's obtaining acceptable documentation from the developer. A contractor must obtain, in good faith and at the time the contract is executed, a properly completed exemption certificate or other written statement from the customer (developer) explaining that the realty being improved has been dedicated to and accepted by a governmental entity.

If the claimed exemption is not clear, the contractor may request additional proof of exemption from the customer. A letter of acceptance or other written confirmation signed by an authorized representative of the governmental entity is sufficient to relieve the contractor from further inquiry.

Once the acceptable documentation has been obtained, improvements are considered for the primary use and benefit of the exempt entity. It does not matter if the contractor's contract with the developer is separated or lump-sum. The contractor may issue an exemption certificate to suppliers when purchasing incorporated materials, qualifying

consumables and qualifying taxable services. The contractor must pay tax on machinery, equipment and all other taxable items not qualifying for the exemption, even when used to perform the development work.

As of Oct. 1, 2003, the water-related exemptions in Tax Code Sec. 151.355 changed to require that the equipment, services and supplies used in water conservation, desalination, availability, precipitation enhancement or to construct certain wastewater systems be used solely for that purpose to qualify for the exemption.

Quasi-Exempt Entities

Taxpayers must be careful in choosing the form of contract for work done for entities that are exempt under provisions other than Texas Tax Code §§ 151.309 and 151.310.

Telephone cooperatives illustrate the issue:

> *Example*
>
> Telephone cooperatives are exempt from paying sales tax on their purchases under Texas Utilities Code § 162.062. Telephone cooperatives are not exempt under Texas Tax Code §§ 151.309 or 151.310. As a result, the exemption directly available to the telephone cooperative does not pass through to the contractor under a lump-sum contract to improve realty because a lump-sum contractor is the "consumer of tangible personal property furnished by him and incorporated into the property of his customer."[313] The lump-sum contractor may not issue a resale or exemption certificate to suppliers for lump-sum contracts with telephone cooperatives.
>
> However, if the contract is separated the contractor may accept a properly completed exemption certificate in lieu of collecting tax on the charge for the incorporated materials.[314]

"Caught in the Middle" - Contracts with Exempt Entities: Purchases of Taxable Services, Supplies and Rental Equipment by the "Middleman"

When purchasing real property improvement services, such as new construction or repair and remodeling, exempt organizations defined in Tax Code §§ 151.309 or 151.310 commonly employ general contractors or engineering firms for these projects. Frequently,

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313 Texas Tax Code § 151.056(a).

314 Comptroller Hearing No. 43,265 (2004) (STAR No. 200401433H).

questions arise about the applicability and responsibility for sales and use taxes on taxable items purchased, leased or rented to complete these projects.

For example, assume a city hires a contractor to repair a city road. This contractor will need to rent barricades for use on the job site. The rental of equipment that the contractor will use in the performance of the contract is subject to sales tax. The contractor may not issue a resale certificate to the barricade vendor because the contractor is the end user of the barricades. The contractor is purchasing the barricades for use in completing the job and is not re-renting the barricades to the city. Nor may the contractor issue an exemption certificate to the barricade vendor. The exempt status of the city does not flow through to the contractor. Therefore, the contractor must pay tax on the rental of the barricades.

There are, however, some exemptions that a contractor may claim on purchases necessary to complete a contract for real property improvement for an exempt entity. These exemptions are found in Tax Code § 151.311(a) and (b).

Example

A contractor may issue an exemption certificate in lieu of paying tax on purchases of taxable items incorporated into the property of the exempt entity and on certain types of consumable items the contractor uses to complete the job. Machinery and equipment are specifically excluded from this exemption. For example, if a contractor needed to rent a backhoe to complete the job, the contractor owes tax on the backhoe rental.

If the contractor wants reimbursement for the rental of the equipment plus tax, the contractor may build the cost of the rental into the pricing of a lump-sum contract, or separately state a reimbursement amount for the rental of the equipment plus tax on the equipment. For example, if the cost for rental of the equipment is $10,000 plus $825 tax, the contractor can state on the invoice:

Reimbursement for equipment rental	$10,000
Reimbursement for sales tax on equipment rental	825
Total reimbursement	$10,825

Often, an exempt entity (such as the city in our example above) is reluctant to pay a “tax” reimbursement. The exempt entity should be

aware, however, that paying the tax reimbursement is simply paying an expense or reimbursing the contractor for a cost incurred in completing the contract. The exempt entity is not **paying** sales tax to the contractor on a purchase for its use that it would normally claim as an exempt purchase.

Nontaxable Services. An exempt entity may purchase nontaxable services, such as an engineering service. The provider of this nontaxable service may, depending on the terms of the contract, seek reimbursement from the exempt organization for costs incurred in performance of the contract, including taxes paid to vendors of taxable items.

Example

For this example, let's assume our city hired an engineer to create the specifications for a new county building to be built on a new parcel of land purchased by the city. To begin the project, the engineer would need to purchase taxable surveying services in order to learn the exact boundaries of the property. Again, the exempt status of the city does not flow through to the engineer so the engineer must pay tax to the surveyor on the charge for boundary surveying.

If the engineering service wants reimbursement for the cost of the surveying plus tax, it may, like the contractor, separately state a reimbursement amount for the surveying, plus tax on the surveying. For example, if the cost of the surveying is $1,000 plus $82.50 tax, the engineer can state on the invoice:

Reimbursement for taxable surveying	$1,000.00
Reimbursement for sales tax on taxable surveying	82.50
Total reimbursement	$1,082.50

As with a contractor, the exempt entity should be aware that, in paying the reimbursement, the exempt entity is not paying sales tax, but, rather, is reimbursing the engineer for sales tax expense incurred to provide the specifications the city desired.

Clearly Identify Reimbursement. As in the examples above, the tax reimbursement must be clearly identified as "reimbursement for sales tax." If the charge is not clearly identified

as a reimbursement, tax is collected in error and must be either remitted to the state by the contractor or nontaxable service provider or refunded to the customer.

Some exempt entities request that bidders delete all state and local sales tax from their bid estimates or invoices. Bidders, however, may owe tax on purchases to complete the work. When preparing payment for the job, exempt entities should take note of the tax obligations imposed by law on contractors and service providers before deleting all tax related charges from the invoice.

Water-Related Exemptions

The Texas sales tax laws contain an exemption to encourage Texans to conserve water. The exemption applies to equipment, supplies, and services used solely for certain types of water conservation.

For this exemption, "solely" means the equipment, services, or supplies are used exclusively for the stated water conservation purpose. For example, the cost of a water dam to be placed into a toilet tank is used solely to save water, so it qualifies for the exemption. A washing machine that has special features to conserve water does not qualify, however, because it is used to wash clothes, not solely to reduce water use.

The water-related exemption covers the materials, equipment, supplies, and services used solely in these types of qualifying activities:

- **Rainwater harvesting.** The exemption applies to the costs of rain barrels, gutters that are used solely to route the water into rain barrels. It applies to rainwater collection systems, tanks and cisterns. It also applies to roof washers used in harvesting systems, the screens and filters used for the gutters, barrels, tanks, cisterns and roof washers, and to any collection surface areas that are not used as roofs of a structure or storage area.
- **Water recycling and reuse.** The exemption applies to charges for the chemicals, tanks and cisterns, and water recycling systems for washing machines.
- **Reduction or elimination of water use.** The exemption applies to charges for water dams for toilets, timers attached to sprinkler systems, water displacement devices for toilet tanks, and faucet sensors that shut off water flow.
- **Desalination of surface water or groundwater.** The exemption applies to the charges for cleaning and pickling valves, filters, membranes, pre-filter pumps, product flow meters, salinity meters, and high-pressure control valves.

- **Brush control designed to increase the availability of water.** The exemption applies to the cost of spray equipment, as well as the calibration of the equipment, and to the tractors, bulldozers, and chain saws used solely to control brush to increase the availability of water. It applies to the cost of herbicides purchased for this purpose as well.

Water Supply Districts

Both non-profit and for-profit water supply corporations who process water for sale are eligible for certain exemptions afforded to most manufacturing concerns. This includes machinery and equipment used directly in the water processing operation along with the related labor and material/replacement parts to repair this same equipment. These entities are entitled to purchase any chemicals that became a part of the water processed for sale. Additionally, the cost of materials necessary or essential to operating the processing machinery and equipment are also exempt from tax.[315] Water supply corporations are also eligible to make a tax-free purchase of electricity used to operate water treating equipment, equipment that removed the water from a river, lake or well, or equipment that transported water from its source to a storage tank or holding facility prior to its treatment. If both exempt and taxable uses were metered by a single meter, then the entity was subject to the predominant use test that all manufacturers were subjected to.[316]

The exemption includes equipment, services, or supplies used solely to construct or operate a water or wastewater system certified as a regional system by the Texas Commission of Environmental Quality (formerly known as the Texas Natural Resource Conservation Commission).[317] The Comptroller interprets this to include only equipment (purchased or leased), services, and supplies used solely on that particular project. This provision applies to both lump-sum contracts and separated contracts. This includes utilities to operate the equipment as well as dedicated office trailers or other facilities located at the job site. It also includes all equipment within the office but only if it is used solely at the regional system site.

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315 Texas Tax Code § 151.318.

316 Texas Tax Code § 151.319.

317 Texas Tax Code §151.355(5) and Comptroller Rule 3.318(b)(5)(A).

Divergent Use. Comptroller Rule 3.318(e) addresses a person's responsibility if a taxable divergent use is made of any item purchased tax-free under the exemption allowed by Texas Tax Code § 151.355.[318]

There is a similar exemption for equipment, services, or supplies used solely to construct or operate a water supply or wastewater system by a private entity who is a member of a public-private partnership, as certified by the political subdivision that is a party to the project.[319] The construction company would be the "private entity" in partnership with the political subdivision.

The operator of the water supply or wastewater system should provide the construction company with a valid exemption certificate before the construction company makes purchases tax-free. Once the construction company has received the exemption certificate (if applicable) from the water operator, the contractor may issue an exemption certificate of their own citing the appropriate statutory reference.[320]

Tax Refunds on Equipment Used on Water & Wastewater Projects.

Contractors performing construction work for exempt entities, or for certain water supply companies, may be eligible for refunds of sales tax paid on purchased or leased equipment, services or supplies. The equipment, services or supplies must be used solely to construct or operate a water or wastewater system certified as a regional system by the Texas Commission of Environmental Quality or on a public-private partnership certified by the political subdivision that is a party to the project.[321]

In order to qualify, the project owner must first apply to the Texas Commission on Environmental Quality ("TCEQ") for certification as a regional system.[322] The TCEQ is

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318 Texas Tax Code §151.355 exempts the following: equipment, services, or supplies used solely to construct or operate a water or wastewater system certified by the Texas Commission on Environmental Quality as a regional system; and equipment, services, or supplies used solely to construct or operate a water supply or wastewater system by a private entity as a public-private partnership as certified by the political subdivision that is a party to the project.

319 Under Texas Tax Code §151.355(6) the private entity partner may claim an exemption for purchases or rentals of equipment, services, or supplies.

320 Comptroller Letter No. 200411894L (November 23, 2004).

321 *See* Tex. Tax Code § 151.355(5).

322 *See* Texas Tax Code § 151.355(5). The TCEQ's website is available here: https://www.tceq.texas.gov/

authorized under the Texas Water Code to provide regional certification for water and sewer utilities that meet any one of the following criteria:

- One owner and one large system serves several different communities or subdivisions;
- One owner and several isolated systems each provide service to one or more communities or subdivisions;
- Several owners each own one or more individual systems that are operated through a centrally coordinated operating system; or
- Several owners each own one or more individual systems that are operated through a central wholesale provider.

After the project owner is certified and TCEQ lists the project as a regional system, the contractor may request a refund of the sales taxes paid on qualifying equipment and repair and replacement parts for that equipment.

Another exemption is available for equipment, services, or supplies used solely to construct or operate a water supply or wastewater system by a private entity as a public-private partnership as certified by the political subdivision that is a party to the project.[323]

[323] *See* Tex. Tax Code § 151.355(6).

Chapter VIII – Performing Work in Declared Disaster Areas

Performing Work in Declared Disaster Areas.

Construction services performed in declared disaster areas may or may not be taxable, depending upon the circumstances. The taxability of construction work depends upon the type of customer, the type of work, and the type of contract used by the contractor.

Cleaning, Restoring, and Repairing Tangible Personal Property

Disaster victims may claim a sales tax exemption on separately-stated charges for labor to repair tangible personal property- such as furniture or appliances- damaged by the disaster.[324] The exemption also applies to labor charges to launder or dry clean damaged clothes or property.[325]

However, the exemption does not extend to materials. Under a separated contract, the customer owes tax on charges for materials. If the repairman fails to separately-state the labor charge, then the entire charge is taxable.[326]

To claim the exemption from tax on labor, the owner must give a completed exemption certificate to the repairman. The certificate must show both the repairman's and the customer's names, the items being repaired, and include the reason for claiming the exemption.

> *Example*
>
> Hurricane Harvey floods Bubba's fish market in Aransas County, which is located in a declared disaster area. Cleaning & Restoration Services ("CRS") removes a refrigerator from Bubba's market, takes it back to its warehouse, and repairs the electrical components. CRS sends Bubba a bill with separately-stated charges for labor to repair the refrigerator and the cost of the new wiring used. In lieu of paying sales tax on the labor charge by CRS, Bubba may give CRS a

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[324] Comptroller Rule § 3.292(g)(1); Comptroller Rule § 3.357(d)(9); Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), *available at*: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3;

[325] Comptroller Rule § 3.310(h).

[326] Comptroller Rule § 3.292(g)(1); Comptroller Rule § 3.357(d)(9); Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), *available at*: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3.

completed exemption certificate that states: "Repair of appliance due to Hurricane Harvey in Aransas County."[327]

Since the exemption does not extend to materials, CRS must collect sales tax from Bubba on the separately-stated charge for the new wiring. CRS, in turn, should not pay sales tax on its purchase of the wiring. Instead, CRS should give a resale certificate to the vendor when it buys the wire.

Landscaping

Arborists' services, such as cutting down or cutting up a damaged or dead tree in a declared disaster area, are not taxable.[328] However, charges to haul away branches, limbs, or trees are considered taxable waste removal services.[329]

To claim the exemption from sales tax on qualifying labor charges, the owner must provide a completed exemption certificate to the seller. The certificate must include both the seller's and the owner's (purchaser's) names and addresses, a description of the type of arborist services performed, and a description of the reason for claiming the exemption.[330]

Example

Bubba hires Arborists Plus to cut down and remove the damaged tree that fell on his home. To claim the exemption from sales tax on the charges for cutting down the damaged tree, Bubba should give a certificate to Arborists Plus that states: "Service to cut down a damaged tree due to declared natural disaster in Aransas County."[331] Arborists Plus's separately-stated charges to haul away the branches from Bubba's tree are taxable.

Contractors should separately state charges for taxable and nontaxable services because the law allows the Comptroller to presume that a single charge for taxable and nontaxable

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327 *See id.*

328 Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), *available at*: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3.

329 *See id.*

330 *See id.*

331 *See id.*; *See* Texas Comptroller of Public Accounts, *Declared Natural Disasters and Emergencies Tax Help*, available at: https://comptroller.texas.gov/taxes/resources/disaster-relief.php.

services is entirely taxable if the taxable portion is greater than five percent (5%) of the total charge.[332]

Example

If Arborists Plus bills a single amount to Bubba for both cutting down the damaged tree and hauling away the tree limbs, then the Comptroller may presume that the entire charge is taxable if the service to haul away the tree limbs is greater than 5% of the total bill.

Demolition

Charges for the complete demolition and partial demolition of residential structures are not taxable.[333] In addition, charges for the complete demolition of an existing non-residential structure are not taxable.[334] In declared disaster areas, an owner may also claim an exemption for otherwise taxable labor charges incurred to partially demolish non-residential structures.[335]

Example

When Bubba realizes that the storage building behind his market cannot be salvaged, he hires a demolition contractor named Demos-R-Us to demolish the building. Bubba also hires Demos-R-Us to partially demolish a damaged area of the kitchen in his market. Technically, only the partial demolition of the kitchen requires an exemption certificate for Demos-R-Us to forego collecting tax from Bubba because the complete demolition of the shed is non-taxable. However, Demos-R-Us should obtain an exemption certificate covering both activities to avoid audit issues.

Removing and Discarding Waste

Charges for removing and disposing of debris or other waste, such as destroyed furniture, in a disaster area are taxable as waste removal services.[336]

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332 *See id.*

333 *See* Comptroller Hearing No. 101,913 (STAR 201012948H) (2010).

334 *See* Comptroller Rule § 3.357(a)(11).

335 Comptroller Publication No. 94-187 (February 2006) (STAR No. 200602645L).

336 *See* Comptroller Rule § 3.356.

Example

CRS hauls away and disposes of the furniture and contents from Bubba's home and market that cannot be salvaged. CRS must charge sales tax on the full charge for this service.

Rebuilding Nonresidential Structures

Special exemptions apply to construction work performed on nonresidential structures in declared disaster areas. Non-residential structures are properties like restaurants, stores, and office buildings; they are not family dwellings.[337]

In a declared disaster area, property owners may claim an exemption from sales tax on separately-stated charges for otherwise taxable labor to repair, remodel, or restore non-residential structures damaged by the disaster.[338] Charges for the materials used to perform the repairs are taxable. To claim the exemption on the labor charge, the property owner should give the contractor a completed exemption certificate.[339]

If a contractor working in a declared disaster area charges a lump-sum price for both labor and materials, the entire charge is taxable.

Example

Bubba hires Quick-Rebuild to repair and remodel the shrimp market, a non-residential structure, under a lump-sum contract. Quick-Rebuild tears the market down to the studs and begins rebuilding the wiring, sheet rock, and floors. If Quick-Rebuild charges Bubba a lump-sum charge for both labor and materials, Quick-Rebuild must charge and collect sales tax on the full amount. But, if Quick-Rebuild's contract separately-states the materials and labor charge, then Bubba may give Quick-Rebuild an exemption certificate in lieu of paying tax on the labor charge.

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337 *See generally* Comptroller Rule § 3.357 for the definition of "residential" property. Non-residential properties are properties that do not fit under the definition of "residential."

338 Comptroller Publication No. 94-182, *Disasters and Texas Sales Tax* (April 2006), *available at*: https://comptroller.texas.gov/taxes/publications/94-182.php#faq3.

339 *See id.*

Rebuilding Residential Structures

"Residential structures" means family dwellings, including apartment complexes, nursing homes, condominiums, and retirement homes.[340] The labor to repair, remodel, or restore residential real property is nontaxable.[341]

Charges for materials incorporated into the repair, remodel, or restoration of residential real property are taxable.[342] Therefore, a contractor must collect tax from his customer on separately-stated charges for materials. But, if the contractor bills lump-sum, then the contractor should not charge tax on any portion of the contract price; instead, he should pay sales tax when he purchases the materials.

Example

Bubba's home is a residential structure. Bubba hires Fast-Repair to repair and remodel his partially-destroyed home under a time and materials contract. Fast-Repair tears the house down to the studs and replaces the wiring, plumbing, and sheetrock. Because a time and materials contract is treated as a separated contract, Fast-Repair should not charge sales tax on labor charges to repair Bubba's home. However, Fast-Repair must charge sales tax on the price of materials incorporated into the remodel because the law views Fast-Repair as having sold the materials to Bubba. As a result, Fast-Repair can provide a resale exemption certificate when it purchases the materials from its vendor that it will resell to Bubba.

Out-of-State Businesses

An out-of-state business entity that enters Texas at the request of an in-state business under a mutual assistance agreement, or that is an affiliate of an in-state business entity, is exempt from Texas licensing and registration requirements if its business in Texas is limited to performing disaster- or emergency-related work during a disaster period.[343]

An out-of-state entity will not be considered 'engaged in business' in Texas if the entity's presence in Texas is solely for performing disaster- or emergency-related work during a

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340 *See id.*

341 Comptroller Publication No. 94-116, *Real Property Repair and Remodeling* (94-116); *see also* Comptroller Rule § 3.357.

342 *See* Comptroller Rule § 3.291.

343 *See* Tex. Tax Code § 151.0241; Tex. Bus. & Comm. Code Ch.112.

disaster response period.[344] An out-of-state entity will not be required to collect and remit Texas sales and use tax on its sales or purchases of taxable items sold or transferred to its customers during a disaster response period in Texas.[345] However, the entity will owe sales tax on its purchases of taxable items for its own use.[346]

344 *See* Comptroller Rule § 3.286(a)(4)(J).

345 *See* Texas Comptroller of Public Accounts, *Declared Natural Disasters and Emergencies Tax Help*, *available at*: https://comptroller.texas.gov/taxes/resources/disaster-relief.php.

346 *See id.*

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